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No.

In the Supreme Court of the United States

OCTOBER TERM, 1980

UNITED STATES OF AMERICA, PETITIONER

v.

VOGEL FERTILIZER COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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QUESTION PRESENTED

Section 1561(a) of the Internal Revenue Code of 1954 (26 U.S.C.) provides that a "controlled group of corporations" shall be limited to a single corporate surtax exemption. Under Section 1563(a) (2), a "controlled group of corporations" includes a "brother-sister group," which is defined as "[t]wo or more corporations if 5 or fewer persons who are individuals * * * own * * * stock" possessing two prescribed and differing percentages of the total combined voting power of all classes of voting stock or of the total value of all classes of the stock of each corporation.

The question presented is whether the statutory definition is met if the "5 or fewer persons" own the prescribed stock singly or in combination, as the governing Treasury Regulations provide, or whether each person whose stock is to be taken into account must own stock in each corporation of the group, as the decision below held.

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The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Claims in this case.

OPINION BELOW

The opinion of the Court of Claims (App. A, *infra*, 1a–42a) is not yet reported.

JURISDICTION

The opinion of the Court of Claims was filed on August 13, 1980. The order denying rehearing en banc was entered on October 3, 1980. (App. B, *infra*, 43a). The judgment of the Court of Claims was entered on November 28, 1980 (App. C, *infra*, 44a). The jurisdiction of this Court is invoked under 28 U.S.C. 1255.

STATUTE AND REGULATIONS

The relevant provisions of Sections 11(d), 1561(a) and 1563(a) (2) of the Internal Revenue Code of 1954 (26 U.S.C.), and of Treasury Regulations, Section 1.1563-1(a)(3)(26 C.F.R.), are set forth at App. D, *infra*, 45a–48a.

STATEMENT

1. Respondent Vogel Fertilizer Company is an Iowa corporation in the business of selling farm fertilizer products at retail to local customers. During 1973–1975, respondent had only common stock issued and outstanding, which was owned by Arthur Vogel (113,575 shares—77.49%) and Richard Crain (33,000 shares—22.51%) (App. A, *infra*, 2a).

Vogel Popcorn Company is a separate corporation engaged in a business unrelated to respondent. During

1973–1975, Vogel Popcorn had issued and outstanding 440,062 shares of common stock, all of which was owned by Arthur Vogel, and 62,866 shares of voting preferred stock, all of which was held by Arthur Vogel as trustee of the Alex Vogel Family Trust. As a result, Arthur Vogel owned 87.5% of all classes of Vogel Popcorn stock entitled to vote. The Alex Vogel Trust in turn owned 12.5% of such stock (App. A, *infra*, 2a).

In its corporate income tax returns for the taxable years 1973–1975, respondent originally treated itself and Vogel Popcorn as members of a brother-sister controlled group of corporations as defined by Section 1563(a) (2). This position was in accord with the governing Treasury Regulations (Section 1.1563–1(a) (3)), which provides that the term "brother-sister controlled group" means two or more corporations if the same five or fewer shareholders own, either singly or in combination, stock possessing—(A) at least 80% of the total combined voting power of all classes of voting stock of each corporation; and (B) more than 50% of the total combined voting power of all classes of voting stock or more than 50% of the total value of all classes of stock of each corporation, taking into account the stock ownership of each person only to the extent such stock ownership is identical with respect to each such corporation (App. A, *infra*, 2a, 4a–5a).

Because it treated itself as a member of a controlled group of corporations, respondent did not claim the full corporate surtax exemption provided by Section 11(d) of the Internal Revenue Code of 1954. For its taxable years ended November 30, 1973 and 1974, respondent elected to utilize the multiple surtax exemption under Sections 1562 and 1564(a) and to pay the multiple surtax penalty imposed by Section 1562(b). For the taxable year ended November 30, 1975, respondent elected under Section 1561(a) (2) to allocate the single

surtax exemption then allowed to members of a controlled group of corporations entirely to Vogel Popcorn (App. A, *infra*, 3a).

Respondent thereafter filed timely claims for refund for each of the years in question. In such claims, respondent took the position that it and Vogel Popcorn were not members of a controlled group of corporations and that therefore it was entitled to a full surtax exemption for each taxable year. After the Internal Revenue Service disallowed respondent's claims, it commenced this refund suit in the United States Court of Claims (App. A, *infra*, 3a).

2. A divided panel of the Court of Claims upheld respondent's claims (App. A, *infra*, 1a–36a). It first pointed out that the dispute between the parties involved only the 80% test of Section 1563(a) (2)(A). Specifically, the question presented was whether Richard Crain, who held no stock in Vogel Popcorn, could be counted as one of the five or fewer persons who held 80% of the stock of each corporation. In arguing that Richard Crain could not be so counted, respondent conceded that the governing Regulations (Section 1.1563–1(a) (3) (ii)) explicitly provided that "the five or fewer persons" can own 80% of the stock of each corporation, singly or in combination, and included an example corresponding exactly to this case (App. A, *infra*, 6a).

After noting that three circuits had upheld the validity of the Regulation which was the basis of the government's position,[1] the Court of Claims struck down the Regulation and instead approved "the statutory construction made by the Tax Court in

[1] *Fairfax Auto Parts of Northern Virgina, Inc.* v. *Commissioner*, 548 F.2d 501 (4th Cir.), cert. denied, 434 U.S. 904 (1977); *Allen Oil Co.* v. *Commissioner*, 614 F.2d 336 (2d Cir. 1980); *T.L. Hunt, Inc* v. *Commissioner*, 562 F.2d 532 (8th Cir. 1977).

Fairfax Auto Parts of Northern Virginia, Inc. v. *Commissioner*, * * * 65 T.C. [798] at 802–803 [(1976), rev'd, 548 F.2d 501 (4th Cir.), cert. denied, 434 U.S. 904 (1977) as] the most careful and best analysis of the statute to date" (App. A, *infra*, 8a; footnote omitted). In the Court of Claims' view, the statutory term "each such person" in the 50% test of Section 1563(a) (2) (B) applies as well with respect to the 80% test of Section 1563(a) (2) (A). As a result, the court concluded that for a person's stock ownership to be taken into account for purposes of the 80% test, that person must own stock in each member of the brother-sister controlled group (App. A, *infra*, 10a).

In so holding, the Court of Claims admitted that "the different view taken by Treas. Reg. § 1.1563–1(a) (3) is not wholly unreasonable as a construction of the words appearing in section 1563(a) (2)" (App. A, *infra*, 12a). However, the court ruled that the Regulation was inconsistent with the legislative history and was unreasonable (App. A, *infra*, 10a).

3. The dissenting judge would have upheld the validity of the Regulation (App. A, *infra*, 36a–42a). As he saw the matter, "the issue is not whether [respondent's] interpretation is *as* reasonable as [the government's]; clearly that will be true in certain given factual situations. The issue is whether [respondent] has carried its heavy burden of showing the regulation to be unreasonable and plainly inconsistent with the statute (emphasis in original)" (App. A, *infra*, 38a).

In the dissenting judge's view, respondent did not meet this burden. Addressing the facts of this case, the dissent noted that during the years at issue, Arthur Vogel owned 77.4% of the only class of stock of Vogel Fertilizer Company. During the same years, he had 87.5% of Vogel Popcorn. Hence, using his stock alone, Arthur Vogel had the "power to direct the op-

erations of both corporations and to cause the corporations to operate as a unified economic enterprise" (App. A, *infra*, 41a). Although Section 1563(a) was directed at precisely such a case, "[y]et the majority holds that the two corporations were not brother-sister and, hence, were each entitled to a full surtax exemption" (*ibid.*)

The dissent further noted that, if Richard Crain owned but a single share of stock in Vogel Popcorn, then the two corporations would have constituted a brother-sister group even under the majority's interpretation (App. A. *infra*, 41a). Absent any proof "that Congress intended the mechanical test which the majority has in mind and which leads to the unreasonable results just described" (App. A, *infra*, 42a), the dissent would have disallowed respondent's claim on the authority of the Regulation.

REASONS FOR GRANTING THE PETITION

1. In holding that respondent and Vogel Popcorn were not members of a "brother-sister" controlled group of corporations within the meaning of Section 1563(a) of the Internal Revenue Code because the same persons were not shareholders in both corporations, the Court of Claims acknowledged that its decision squarely conflicted with *Fairfax Auto Parts of Northern Virginia, Inc.* v. *Commissioner*, 548 F.2d 501 (4th Cir. 1977), rev'g 65 T.C. 798 (1976), cert. denied, 434 U.S. 904 (1977); *Allen Oil Co.* v. *Commissioner*, 614 F.2d 336 (2d Cir. 1980), rev'g 38 T.C.M. 355 (1979); and *T.L. Hunt, Inc.* v. *Commissioner*, 562 F.2d 532 (8th Cir. 1977), rev'g 35 T.C.M. 966 (1976). Subsequent to the decision below, the Fifth Circuit has aligned itself with the Court of Claims. See *Delta Metalforming Co.* v. *Commissioner*, No. 78-3699 (Dec. 8, 1980).

Hence, as matters now stand, the Second, Fourth, and Eighth Circuits have upheld the government's position, which finds explicit support in the Treasury Regulations (Section 1.1563-1(a) (3) and Example (1)), that two corporations constitute a brother-sister controlled group as long as five or fewer shareholders own the statutorily prescribed percentage of stock, singly or in combination. On the other hand, the Tax Court, the Court of Claims in the decision below, and the Fifth Circuit have taken the contrary position and have held the governing Treasury Regulation to be invalid. This Court should resolve the conflict and establish a uniform rule for the proper administration of the revenue laws.

Moreover, the question presented has considerable administrative importance. We are advised by the Internal Revenue Service that there are currently 223 cases pending in the courts involving approximately $3.5 million. Two of these cases are awaiting argument in the courts of appeals.[2] And apart from the application of Section 1563(a)(2) itself, the issue of multiple corporate surtax exemptions materially affects a host of other provisions of the Internal Revenue Code. See Sections 535(c) (accumulated earnings tax credit), 804(a)(3) and 809(d)(10) (limitation on small business deduction of life insurance companies), Sections 404(a)(1)(C) and 414(b) (deduction by employers for contributions to stock bonus, revision, profit-showing or annuity plans), Section 46(a)(6) (computation of refund limitation on investment credit), Section 58(b) (apportionment of exemption from minimum tax), and Section 179(d) (7) (limitation on additional first-year depreciation). Thus, the fiscal significance of the ques-

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[2] *Baloian* v. *Commissioner*, Nos. 78-2438 and 78-2508 (9th Cir.); *Davidson Chevrolet Co.* v. *Commissioner*, No. 80-1041 (6th Cir.).

tion presented cannot be limited to Section 1563(a) alone.

2.a. Section 1561 of the Code (App. D, *infra*, 45a) provides that the members of a "controlled group of corporations" shall be limited to a single surtax exemption under Section 11(d). Section 1563(a)(2) (App. D, *infra*, 46a–47a) defines the terms "controlled group of corporations" as follows:

> (a) CONTROLLED GROUP OF CORPORATIONS—For purposes of this part, the term "controlled group of corporations" means any group of—
>
> * * * * *
>
> (2) BROTHER-SISTER CONTROLLED GROUP—Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing—
>
> (A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and
>
> (B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, *taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation* (Emphasis supplied).

Under the statute, subparagraphs (A) and (B) set forth an 80% test and a 50% test. The only substantive difference between the two tests is the italicized language of subparagraph (B), which introduces a limita-

tion not applicable to the 80% test. Thus, the stock owned by any or all of the five persons may be taken into account in determining whether the 80% test has been met. On the other hand, in determining whether the 50% test has been satisfied, it is necessary to ascertain which of such persons owns stock in both of the corporations and how much each of them owns. Only to the extent that a person owns stock in each of the corporations is his stock taken into account for purposes of the 50% test. Accordingly, a person who owned no stock in one of the corporations would be excluded from consideration for purposes of that test. That is the import of the italicized language of subparagraph (B)—"taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation."

Applying the statute to the facts of the instant case, Arthur Vogel owned 77.49% of the voting stock of respondent Vogel Fertilizer and 87.5% of the voting stock of Vogel Popcorn. Richard Crain owned the remaining 22.51% of respondent Vogel Fertilizer's voting stock. Hence, using the figure 77.49% as the identical stock ownership of Arthur Vogel, it is clear that "5 or fewer persons" owned more than 50% of the voting stock of both corporations. Since it can hardly be disputed that "5 or fewer persons" owned at least 80% of the voting stock of each corporation—unless one adds unstated conditions to Section 1563(a)(2)(A)—the Commissioner properly determined that respondent and Vogel Popcorn were entitled to only one surtax exemption, as originally reported on their returns.

The foregoing analysis is squarely supported by Treasury Regulations, Section 1.1563-1(a)(3) (26 C.F.R.) (App. D, *infra*, 47a-48a), which provides that "[t]he term 'brother-sister controlled group' means two or more corporations if the same five or fewer persons who are individuals * * * own * * * *singly or*

in combination, stock possessing * * * [the requisite voting power]" (emphasis added). Indeed, the Regulations (Section 1.1563-1(a)(3)(ii)) set forth the following example, which demonstrates that the 50% test may be satisfied even though each of the "5 or fewer persons" does not own stock in each corporation.

> Example (1). The outstanding stock of corporations P, Q, R, S, and T, which have only one class of stock outstanding, is owned by the following unrelated individuals:

Individuals	Corporations					Identical Ownership
	P	Q	R	S	T	
A	60%	60%	60%	60%	100%	60%
B	40%	—	—	—	—	—
C	—	40%	—			
D	—	—	40%	—		
E	—	—	—	40%	—	—
Total	100%	100%	100%	100%	100%	60%

> Corporations P, Q, R, S, and T are members of a brother-sister controlled group.

b. In holding that the 50% test of subparagraph (A) is not satisfied unless each of the "5 or fewer persons" owns stock in each corporation, the Court of Claims relied upon the phrase "each such person" in subparagraph (B) and concluded that the phrase refers to the "5 or fewer persons" for purposes of both the 80% *and* 50% tests (App. A, *infra*, 10a). Quoting with approval from the Tax Court's opinion in *Fairfax Auto Parts of Northern Virginia, Inc.* v. *Commissioner*, *supra*, 65 T.C. at 802-803, the Court concluded that the statute "requires the same persons to be in the group of controlling stockholders used in both tests" (App. A, *infra*, 10a-11a).

But the fundamental error of the Court of Claims (as well as the Tax Court) in interpreting Section

1563(a)(2) was to ignore the fact that the phrase "each such person" is found only in subparagraph (B) with respect to the 50% test. Thus, the natural reading of "each such person" is that it refers only to those persons owning more than 50% of the voting stock of each corporation, in subparagraph (B), rather than modifying the "5 or fewer persons" set forth in the prefatory part to paragraph (2). Indeed, if such were not the case, one could well conclude (contrary to even the decision below) that the entire italicized portion of subparagraph (B) refers to the "5 or fewer persons" with the result that the 80% test would be met only if each of the "5 or fewer persons" owned stock in both corporations.

The legislative history of Section 1563(a) confirms the correctness of our submission that the 80% test and the 50% test are independent parts of the statute. The 80% test antedated the 50% test. As originally enacted by the Revenue Act of 1964, Pub. L. No. 88-272, Section 235(a), 78 Stat. 120, Section 1563(a)(2) defined a brother-sister controlled group to be two or more corporations, if 80% of the total combined voting power or value of the shares was owned by one person. Because that rule failed to prevent the abuse of a group of corporations operated as a single economic entity claiming multiple surtax exemptions, Congress expanded the definition of a controlled group in the Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(c), 83 Stat., 602. To make the rule applicable in more situations, the stock ownership of up to five persons was to be taken into account. However, Congress added the 50% test to assure that there would be common control of each of the corporations by some of the group. As the Treasury's General Explanation contained in the *Tax Reform, 1969: Hearings Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess. 5394 (1969), states—

> However, in order to insure that this expanded definition of brother-sister controlled group applies only to those cases where the five or fewer individuals hold their 80 percent in a way which allows them to operate the corporations as one economic entity, the proposal would add an additional rule that the ownership of the five or fewer individuals must constitute more than 50 percent of the stock of each corporation considering, in this test of ownership, stock of a particular person only to the extent that it is owned identically with respect to each corporation.

This explanation supports the provision of the Regulations that the 80% test will be met if the "5 or fewer persons" own stock of both corporations, either singly or in combination. The juxtaposition of the phrase referring to stock of "a particular person" (for purposes of the 50% test) to "the five or fewer individuals" (as to which the 80% test is applied) makes it clear that different persons may be taken into account in applying the 80% and the 50% tests and that the common ownership requirement applies only to the 50% test. In short, the 80-percent and 50-percent tests are separate parts of the statute that are to be independently applied. Hence, there is no basis for the importation of the phrase "each such person" from the 50% test into the 80% test, as the decision below construed the statute.[3] Indeed, as the dissenting judge pointed out (App.

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[3]The Court of Claims addressed the Treasury's General Explanation but concluded that it undermined the Regulation because of the references in the Treasury document to "the same five or fewer persons" owning at least 80% of "each corporation" and "these five or fewer individuals" owning at least 50% of the stock of each corporation (see App. A, *infra*, 21a). But these references simply underscore the fact that the same group of five or fewer persons, rather than a different group, is to be considered in applying both the 80% and 50% tests

A, *infra*, 40a–42a), the majority's gloss upon Section 1563(a) would impede the legislative purpose of denying multiple surtax exemptions to those corporations which are operated as a single economic entity. Here, it is clear that Arthur Vogel—owning 77.49% of respondent's voting stock and 87.5% of Vogel Popcorn's voting stock—had the power to operate both corporations as a single economic entity. But under the majority's view, the corporations were not brother-sister and were therefore entitled to two surtax exemptions, a result that would be changed if Richard Crain owned a single share of Vogel Popcorn. It is difficult to imagine that Congress intended the statute to turn upon such minute distinctions which make no economic difference.

3. While we believe that the language of Section 1563(a)(2) and its legislative history support the conclusion that the 50% test is satisfied if the "5 or fewer persons" own stock in each corporation either singly or in combination, the question in this case is not whether the Court of Claims has reached a more reasonable interpretation of the statute. Given the existence of a controlling Treasury Regulation, the question is whether the Regulation is *a* reasonable interpretation of the statute. This Court has repeatedly ruled that Treasury Regulations must be upheld if they are not plainly inconsistent with the statute and if they implement the statute in a reasonable way. See, *e.g.*, *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948); *Bingler* v. *Johnson*, 394 U.S. 741, 749–750 (1969); *Fulman* v. *United States*, 434 U.S. 528, 533 (1978); *National Muffler Dealers Assn.* v. *United States*, 440 U.S. 472 (1979).

Here, it cannot be disputed that the controlling Treasury Regulation interprets the statutory language in a reasonable manner. Indeed, apart from the three

circuits that have upheld the Regulation, even the Court of Claims "admitted that the different view taken by Treas. Reg. § 1.1563-1(a)(3) is not wholly unreasonable as a construction of the words appearing in section 1563(a)(2)" (App. A, *infra*, 12a). And, as we have shown, that construction is consistent with the legislative history and purpose of the pertinent statutory provisions. It was, therefore, not open to the court to adopt an interpretation at variance with the Regulation even though it believed that its reading of the statute was equally or even more reasonable. In short, a court cannot set a reasonable Treasury Regulation aside in favor of another interpretation that it deems preferable. In this respect, this Court's admonition in *United States* v. *Correll*, 389 U.S. 299 (1967), is particularly appropriate. In upholding the Commissioners' overnight rule concerning the deductibility of meals consumed during business travel, the Court there stated, in terms equally applicable to this case (*id.* at 306–307):

> Alternatives * * * are of course available. Improvements might be imagined. But we do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. * * * The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner.

CONCLUSION

The petition for a writ of certiorari should be granted.

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JANUARY 1981

APPENDIX A

In the United States Court of Claims

No. 69-78

(Decided August 13, 1980)

VOGEL FERTILIZER COMPANY

v.

THE UNITED STATES

Before FRIEDMAN, *Chief Judge*, BENNETT and SMITH, *Judges*.

ON DEFENDANT'S MOTION FOR SUMMARY JUDGMENT AND PLAINTIFF'S CROSS-MOTION FOR SUMMARY JUDGMENT

BENNETT, *Judge*, delivered the opinion of the court:

The issue in this case is the validity of Tres. Reg. § 1.1563-1(a)(3) (1972), which defines the term "brother-sister controlled group" for the purposes of the limited surtax exemption available to multiple corporations. Plaintiff has filed suit for the refund of income taxes for the taxable years ended November 30, 1973, 1974, and 1975. The case is now before the court on the parties' cross-motions for summary judgment. We hold that the regulation is an overly expansive interpretation of I.R.C. § 1563(a)(2) and that plaintiff is not a member of a "brother-sister" controlled group" as that term is used in the statute. Therefore, we grant plaintiff's motion for summary judgment.

Plaintiff, Vogel Fertilizer Company, is an Iowa corporation in the business of selling farm fertilizer products at retail to local customers. Plaintiff has only common stock issued and outstanding, and for all relevant periods, Arthur Vogel held 113,575 shares (77.49 percent) and Richard Crain held 33,000 shares (22.51 percent) of such stock.

Vogel Popcorn Company (hereinafter Vogel Popcorn) is also an Iowa corporation, which is engaged in a business unrelated to plaintiff's. For all relevant periods, Vogel Popcorn had issued and outstanding 440,062 shares of common stock, all of which was held by Arthur Vogel, and 62,866 shares of voting preferred stock, all of which was held by Arthur Vogel as trustee of the Alex Vogel Family Trust. The relative value and voting power of this stock were as follows:

Shareholder	No. of Shares	Voting % of All Classes Entitled to Vote	Percent of Value of All Classes of Stock		
			1973	1974	1975
Arthur Vogel, individually	440,062 Common Stock	87.5	90.66	91.42	93.42
Arthur Vogel, as trustee	62,866 Voting Preferred Stock	12.5	9.34	8.58	6.58

Richard Crain is not related to Arthur Vogel in any manner. Defendant makes no contention that the stock owned by either person may be attributed under I.R.C. § 1563(d) to the other. Moreover, defendant has expressly conceded that under the attribution rules Arthur Vogel could not be considered the constructive owner of the shares held by him as trustee.

Plaintiff timely filed corporate income tax returns for the years in question. In accordance with Treas. Reg. § 1.1563-1(a)(3), plaintiff originally treated itself and Vogel Popcorn as members of a controlled group

of corporations. Plaintiff therefore did not claim the full surtax exemption provided by I.R.C. § 11(d). For the taxable years ended November 30, 1973 and 1974, plaintiff elected to utilize the multiple surtax exemption under I.R.C. §§ 1562 and 1564(a) and to pay the multiple surtax penalty imposed by I.R.C. § 1562(b).[1] For the taxable year ended November 30, 1975, plaintiff elected under I.R.C. § 1561(a)(2)[2] to allocate the single surtax exemption then allowed to members of a controlled group of corporations entirely to Vogel Popcorn.

On November 25, 1976, plaintiff filed timely claims for refund for each of the years in question. Plaintiff asserted that it and Vogel Popcorn were not members of a controlled group of corporations and that, therefore, plaintiff was entitled to a full surtax exemption for each taxable year. After plaintiff's claims were disallowed in full by the Internal Revenue Service, plaintiff timely filed suit in this court.

I

The legal question presented by this case is whether plaintiff and Vogel Popcorn are a "brother-sister controlled group" under section 1563(a)(2). If they are a controlled group, it is undisputed that the limitations imposed by sections 1561 through 1564 would prevent plaintiff from claiming a full surtax exemption.

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[1] During these years the benefits of multiple surtax exemptions were being gradually phased out. Section 1562 was repealed effective December 31, 1974, by sections 401(a)(2) and (h)(1) of the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 600, 604.

[2] Section 1561(a) was amended effective December 31, 1974, by sections 401 (a)(1) and (h)(1) of the Tax Reform Act of 1969, *supra*, 83 Stat. 599, 604.

Section 1563(a)(2) provides that the term "controlled group of corporations" includes:

> (2) BROTHER-SISTER CONTROLLED GROUP—Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing—
>
> (A) at least 80 percent of the total combined voting power of all cases of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and
>
> (B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.

Treas. Reg. § 1.1563-1(a)(3) explains the statute as follows:

> (3) *Brother-sister controlled group.* (i) The term "brother-sister controlled group" means two or more corporations if the same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of the rules contained in paragraph (b) of § 1.1563-3), singly or in combination, stock possessing—
>
> (a) At least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation; and
>
> (b) More than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of

shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.

(ii) The principles of this subparagraph may be illustrated by the following examples:

Example (1). The outstanding stock of corporations P, Q, R, S, and T, which have only one class of stock outstanding, is owned by the following unrelated individuals:

Individuals	Corporations					Identical ownership
	P	Q	R	S	T	
A	60%	60%	60%	60%	100%	60%
B	40%					
C		40%				
D			40%			
E				40%		
Totals	100%	100%	100%	100%	100%	60%

Corporations P, Q, R, S, and T are members of a brother-sister controlled group.

* * * * *

Thus, the regulation for the most part restates the statute. The regulation does, however, add that the stock ownership of the "same" five or fewer persons should be considered "singly or in combination." Example (1) of the regulation illustrates the meaning of this addition. The example indicates that for the purposes of the 80-percent test a person can be considered as one of the five or fewer members of the group controlling shareholders even though such person holds stock only in one corporation.

In this case, there is no question that the 50-percent test in section 1563(a)(2)(B) is met. Arthur Vogel held 77.49 percent of the stock of plaintiff and 87.5 percent (in terms of voting power) of the stock of Vogel Popcorn. The stock ownership is taken into account to the extent that it is identical, *i.e.*, 77.49 percent, which is more than the 50 percent required by section 1563(a)(2)(B).

The dispute here involves only the 80-percent test and specifically whether Richard Crain who holds no stock in Vogel Popcorn can be counted as one of the five or fewer persons who hold 80 percent of the stock of each corporation. Plaintiff concedes that if Example (1) of Treas. Reg. § 1.1563-1(a)(3)(ii) is valid, then Richard Crain's stock can be counted toward the required 80 percent. Plaintiff, however, argues that the regulation is unreasonable and clearly inconsistent with the statute. A person must hold some stock in both corporations, plaintiff contends, before his stock in any corporation can be counted in the 80-percent test.

The validity of Treas. Reg. § 1.1563-1(a)(3) has already been extensively litigated. The first case brought under the regulation was *Fairfax Auto Parts of Northern Virginia, Inc.* v. *Commissioner*, 65 T.C. 798 (1976). The regulation was found to be invalid in a decision reviewed by the full Tax Court with four judges dissenting. The United States Court of Appeals for the Fourth Circuit reversed the Tax Court in a short *per curiam* opinion agreeing with the four dissenting judges. 548 F.2d 501, *cert. denied*, 434 U.S. 904 (1977). The Tax Court has reaffirmed its majority view in a second court-reviewed decision, *Charles Baloian Co.* v. *Commissioner*, 68 T.C. 620 (1977), and has continued to apply section 1563(a)(2) without regard to the regulation in several cases. *See, for exam-*

ple, Davidson Chevrolet Co. v. *Commissioner*, No. 2619-78, T.C. Memo. 1979-414 (Oct. 2, 1979); *Delta Metalforming Co.* v. *Commissioner*, 37 T.C.M. (CCH) 1485 (1978). Two other courts of appeals have subsequently reversed Tax Court decisions and have upheld the regulation. *Allen Oil Co.* v. *Commissioner*, 614 F.2d 336 (2d Cir. 1980), *rev'g* 38 T.C.M. (CCH) 355 (1979); *T.L. Hunt, Inc.* v. *Commissioner*, 562 F.2d 532 (8th Cir. 1977) (2-1 opinion), *rev'g* 35 T.C.M. (CCH) 966 (1976). Appeals from the Tax Court are now pending before several circuits.

II

Although the parties agree on the mechanical operation of the 50-percent test, plaintiff and defendant have very different views on the importance of the 50-percent test relative to the 80-percent test.

In defendant's view, the 80-percent test only measures the closely held nature of the corporations. Thus, if 80 percent of each corporation is held by five or fewer individuals, the 80-percent test is met regardless of whether all of the five or fewer individuals hold stock in only one corporation. Only the 50-percent test measures whether the corporations are in any way related through common stockholders. Under defendant's interpretation, the 80-percent test standing alone has no significance; it only has meaning as one part of a two-pronged test.

Plaintiff believes that defendant's interpretation accords too little scope to the 80-percent test. The 80-percent test, plaintiff argues, is the more important of the two tests, and the proper role of the 50-percent test is subordinate, not superior, to the 80-percent test. Thus, each of the five or fewer persons considered in the 80-percent test must own some stock in

both corporations, and the function of the 50-percent test is to treat corporations as separate entities if the 80 percent is held in such differing proportions with respect to each corporation that the corporations cannot effectively be controlled as one.[3]

III

The statute itself has been fairly criticized as being open to at least four different constructions. Libin & Abramowitz, *Multiple Corporations: A Surprising Interpretation of Sec. 1563(a)(2) in Temporary Regulations*, 2 TAX ADVISER 326, 327-28 (1971). We agree that the correct interpretation of section 1563(a)(2) cannot be resolved solely by reference to the statutory language. Nevertheless we do believe that the statutory construction made by the Tax Court in *Fairfax Auto Parts of Northern Virginia, Inc.* v. *Commissioner*, *supra*, 65 T.C. at 802-03, is the most careful and best analysis of the statute to date.[4] There the

[3] The most obvious example is where the stock of one corporation is held 80 percent by A and 20 percent by B while the stock of another corporation is held 20 percent by A and 80 percent by B. The 80-percent test would be met regardless of which interpretation is correct. The 50-percent test would not be met because the holdings are considered only to the extent that they are identical with respect to each corporation, *i.e.*, 20 percent each for A and B for a total of 40 percent. *See* TECHNICAL EXPLANATION OF TREASURY TAX REFORM PROPOSALS in *Hearings on the Subject of Tax Reform Before House Comm. on Ways and Means*, 91st Cong., 1st Sess. 5170 (1969). Because each stockholder has a much greater investment in one of the corporations, the interests of the stockholders and the corporations are quite distinct.

[4] This construction of the statute was first suggested in Thomas, *Brother-Sister Multiple Corporations—The Tax Reform Act of 1969 Reformed by Regulation*, 28 Tax L. Rev. 65, 77-79 (1972).

Tax Court stated:

> The key words of the statute relevant to an analysis of the issue are:
>
> if 5 or fewer persons * * * own * * *
>
> (A) at least 80 percent * * * of each corporation, and
>
> (B) more than 50 percent * * * of each corporation, taking into account the stock ownership of *each such person* only to the extent such stock ownership is identical with respect to each such corporation. [Sec. 1563(a)(2). Emphasis supplied.]

Since the "five or fewer persons" is the conjunctive subject of both the 80-percent test and the 50-percent test, it cannot be gainsaid that both tests must be satisfied by the same ownership group. However, to gain entrance into the ownership group for purposes of the 50-percent test one must possess stock in each corporation involved since an absence of such stock ownership produces an identical stock ownership of zero or, put another way, no stock ownership at all. If ownership of stock in each corporation involved is a precondition to membership in the ownership group for purposes of the 50-percent test, and the ownership groups for the 50-percent test and 80-percent test are one and the same, it follows in our mind that one must own stock in each corporation before his stock can be taken into account for purposes of the 80-percent test.

Furthermore, the language of the 50-percent test comports with this analysis. The words "each such person" appearing therein refer to the "five or fewer persons" constituting the ownership group, for purposes of both the 80-percent and

> 50-percent tests. The import of such usage is that each person—and not just some of the persons—counted for purposes of the 80-percent test must be also counted for purposes of the 50-percent test. To interpret the statutory language as respondent has done in his regulation is plainly inconsistent with the thrust of the statutory language. Hence, we hold that for a person's stock ownership to be taken into account for purposes of the 80-percent test that person must own stock in each member of the brother-sister controlled group.* * *

Defendant takes exception to the Tax Court's analysis and notes that while the 50-percent test specifically provides for "taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation," the 80-percent test contains no such language. Thus, defendant concludes that there is no specific requirement in the 80-percent test that a person own stock in more than one corporation. Defendant further argues that under the Tax Court's interpretation the 50-percent test would serve no function since it would necessarily be satisfied in any situation in which the 80-percent test was met. This argument attempts to blur the important distinction drawn by the Tax Court between the overlapping ownership required by the 80-percent test and the *identical* overlapping ownership required by the 50-percent test.[5] Contrary to defendant's contentions, the Tax Court's interpretation does not import the requirement of identical ownership into the 80-percent test; it merely requires the same

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[5] The example given in note 3, *supra*, demonstrates a situation where the 80-percent test, but not the 50-percent test, is met.

persons to be in the group of controlling stockholders used in both tests.

Defendant further relies upon the "last antecedent" doctrine to dispute that the phase "each such person" in the 50-percent test refers to the "5 or fewer persons" who are the subject of both tests. This doctrine requires that qualifying words, phrases, and clauses in a statute are to be applied to the words or phrase immediately preceding and are not to be construed as extending to and including others more remote. *Azure* v. *Morton*, 514 F.2d 897, 900 (9th Cir. 1975); *Quindlen* v. *Prudential Ins. Co. of America*, 482 F.2d 876, 878 (5th Cir. 1973). Defendant misunderstands the function of this doctrine, which, for example, would establish (in the absence of clarifying indentation) that the qualifying clause "taking into account the stock ownership of each such person only to the extent such stock owner-

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Defendant further argues that, even assuming *arguendo* that there may be isolated instances in which the 80-percent but not the 50-percent test would be satisfied under the Tax Court's interpretation, in the vast majority of stock ownership patterns, the Tax Court's common ownership requirement for the 80-percent test would come close to eliminating the 50-percent test despite Congress' intent to have two separate tests. As discussed in part II of this opinion, *supra*, regardless of the interpretation chosen, one of the two tests will play a far more significant role than the other. Based on the legislative history and purpose of section 1563(a)(2) discussed in parts IV and VI of this opinion, *infra*, we have concluded that the 80-percent test was intended to be the primary test and must be so treated if it is to have any significance at all. While we disagree with defendant's unsupported factual assertions with respect to the "vast majority" of stock ownership patterns, we do agree that under our interpretation the 50-percent test by itself would result in the exclusion of a group of corporations from treatment as a brother-sister controlled group only in an atypical stock ownership arrangement. This, in our opinion, is precisely what the 50-percent test was intended to do.

ship is identical with respect to each such corporation" only applies to the immediately preceding 50-percent test and not to the more remote 80-percent test. The phrase "5 or fewer persons" is the most immediately preceding reference to "persons" prior to the phrase "each such person." As such, both common English usage and the "last antecedent" doctrine support the Tax Court's interpretation.

Despite the better reasoned construction of the statutory language by the Tax Court, it must be admitted that the different view taken by Treas. Reg. § 1.1563-1(a)(3) is not wholly unreasonable as a construction of the words appearing in section 1563(a)(2). The regulation is, however, clearly inconsistent with the legislative history and unreasonable when the purpose, as well as the bare words, of the statute are considered.

IV

In order to understand the legislative history of section 1563(a)(2), it is necessary to begin with earlier congressional attempts to deal with the tax abuses of multiple corporations. Prior to the Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19, the Commissioner of Internal Revenue had fairly limited powers to curb multiple incorporation for the purpose of claiming extra surtax exemptions. The only provision of the Internal Revenue Code specifically aimed at multiple surtax exemptions was section 1551.[6] Prior to 1964,

[6] The Commissioner could also employ more general powers under section 269 to disallow tax benefits resulting from the acquisition of control of a corporation where the principal purpose of such acquisition is the evasion or avoidance of federal income tax or under section 482 to reallocate deductions, credits, or allowances between two corporations owned or controlled by the

section 1551 disallowed the surtax exemption of a transferee corporation in certain cases if the corporation failed to establish by a preponderance of the evidence that the securing of the exemption was not a major purpose of the transfer. Section 1551 applies to situations where a corporation transferred part or all of its property (other than money) to another corporation created to acquire such property, or not actively engaged in business at the time of the transfer, if there was common control of the two corporations.

The Revenue Act of 1964 expanded the Commissioner's power to deal with multiple surtax exemptions in two ways.

First, sections 1561 through 1563 were added to the Code. These new provisions limited in one of three alternative ways the surtax exemptions available to a "controlled group of corporations." Sections 1561-1563 established a mechanical test relating to stock ownership, and once it was met, the sanctions would apply regardless of any legitimate nontax purposes for the use of more than one corporation.[7] A "brother-sister controlled group" was defined in the 1964 Act as existing where a *single* individual, trust, or estate owned at least 80 percent of the total combined voting power or value of all classes of stock of each of two or

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same interest where necessary to prevent the evasion of taxes or clearly to reflect the income of the corporations.

[7] The mechanical application of sections 1561-1563 is by far the most significant change from the approach taken in section 1551. In Thomas, *Brother-Sister Multiple Corporations—The Tax Reform Act of 1969 Reformed by Regulation*, 28 TAX L. REV. 65, 69 (1972), it is noted that virtually every litigated case under the older section 1551 was decided by a determination of the taxpayer's purpose or motive and that not one case can be found that seriously raised any question as to the control requirements under that statute.

more corporations.[8] *See* H. REP. No. 749, 88th Cong., 1st Sess. (1963), *reprinted in* [1964] U.S. CODE CONG. & AD. NEWS 1313, 1428, 1624, 1964-1 C.B. (Part 2) 125, 243, 446; S. REP. No. 830, 88th Cong., 2d Sess. (1964), *reprinted in* [1964] U.S. CODE CONG. & AD. NEWS 1673, 1825, 1964-1 C.B. (Part 2) 505, 655.

Second, section 1551 was retained and expanded in scope. One of the changes was to apply section 1551 to transfers by an individual (as well as a corporation) to a controlled corporation. Under section 1551(b)(2),

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[8] It is worth noting that in PRESIDENT'S 1963 TAX MESSAGE in *Hearings on the President's 1963 Tax Message Before the House Comm. on Ways and Means*, 88th Cong., 1st Sess. 77 (1963), the Treasury Department originally proposed to define a brother-sister controlled group less stringently than in Treas. Reg. § 1.1563-1(a)(3) under the 1969 change in section 1563(a)(2). Under the proposal, a brother-sister affiliated group would have included any group of two or more corporations if (1) at least 80 percent of the value or voting power of the stock of each of the corporations was owned by not more than five individuals, (2) each of the individuals owned 5 percent or more of the value or voting power of the stock of at least one of the corporations, and (3) each of the individuals owned substantially the same proportion of the voting power or value of the stock of each of the corporations. In determining whether there existed 80-percent common ownership in each of two brother-sister-type corporations in substantially the same proportion, an individual's stock ownership in one corporation would not have been taken into account to the extent it exceeded twice the percentage of his stock ownership in the other corporation.

Thus, it is clear that under the first part of the 1963 proposal an 80-percent overlap of ownership was required. There is no equivalent in the 1969 statute to the second part of the 1963 proposal, but the third part has a very similar function to the 50-percent test in the 1969 statute as construed by plaintiff and this court. Neither one erases the requirement of an 80-percent overlap, and both measure whether the 89 percent is held to a large extent in identical proportions with respect to each corporation.

control was deemed to exist where the individual who made the transfer, together with no more than four individuals, owned at least 80 percent of the value or voting power of the stock in two or more corporations, one of which was the transferee corporation, and where the same individuals owned more than 50 percent of the value or voting power of the stock in each corporation (only taking into account identical stockholdings) after the transfer. *See* H. REP. No. 749, *supra*, [1964] U.S. CODE CONG. & AD. NEWS at 1432, 1638-39, 1964-1 C.B. (Part 2) at 247, 460-61; S. REP. No. 830, *supra*, [1964] U.S. CODE CONG. & AD. NEWS at 1829, 1964-1 C.B. (Part 2) at 659. There are no reported court decisions under section 1551(b)(2) which construe the meaning of this control test.

In 1969, the Treasury Department made several further proposals relating to multiple corporations. One of these was to expand the definition of a brother-sister controlled group in section 1563(a)(2) to consider the stockholdings of up to five persons instead of only one. The Treasury proposal to modify section 1563(a)(2) to apply the same test as section 1551(b)(2) was adopted without change by the Congress. *See* the Tax Reform Act of 1969, Pub. L. No. 91-172, § 401(c), 83 Stat. 602. Therefore, the committee reports on this aspect of the bill are very cursory.[9] The only significant contem-

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[9] The General Explanation in H. REP. No. 91-413 (Part I), 91st Cong., 1st Sess. 99 (1969), *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 1645, 1747-48, 1969-3 C.B. 200, 262, only states:

> "The bill also modifies the present definition of a brother-sister controlled group—i.e., two or more corporations 80 percent or more of the stock of which is owned (by voting power or value) by one individual, estate, or trust. This bill expands this definition to include two or more corporations which are owned 80 percent or more (by

poraneous legislative material in the 1969 change in section 1563(a)(2) is the Treasury Department's explanation of its proposal. The relevant portions of the TECHNICAL EXPLANATION and the GENERAL EXPLANATION OF TREASURY TAX REFORM PROPOSALS in *Hearings on the Subject of Tax Reform Before House Comm. on Ways and Means*, 91st Cong., 1st Sess. 5168-70, 5394-96 (1969), state:

> (b) *Brother-sister controlled group.* Present law defines a brother-sister controlled group as a group of corporations in which the voting stock or value of shares of each member is owned 80 percent by the same person (i.e., individual, estate or trust). Under the proposal, the present definition would be changed so that a group of corporations would constitute a brother-sister controlled group if (1) the same *five* or fewer persons own at least

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voting power or value) by five or fewer persons (individuals, estates, or trusts) provided that these five or fewer persons own more than 50 percent of each corporation when the stock of each person is considered only to the extent it is owned identically with respect to each corporation. In other words, a person who owns 70 percent of one corporation and 30 percent of another corporation is to be treated as owning only 30 percent of each corporation identically. It is only this amount which would be taken into account in applying the 50-percent test."

The Technical Explanation in H. REP. No. 91-413 (Part II), *supra*, at 76, [1969] U.S. CODE CONG. & AD. NEWS at 1956, 1969-3 C.B. 384, only adds: "Subsection (c) of section 401 of the bill amends section 1563(a)(2) of the code to expand the definition of a brother-sister controlled group of corporations. The stock ownership test would be the same test employed in section 1551(b)(2) of the code."

The relevant portion of S. REP. No. 91-552, 91st Cong., 1st Sess. 135 (1969), *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 2027, 2167, 1969-3 C.B. 423, 510, is substantially the same as the General Explanation in the House report.

80 percent of the voting stock or value of shares of each corporation, and (2) these five or fewer individuals own more than 50 percent of the voting power or value of shares of each corporation considering a particular person's stock only to the extent that it is owned identically with respect to each corporation. This definition is the same as that under section 1551 (relating to the disallowance of surtax exemptions and accumulated earning credits in cases of transfers in order to secure the exemption or credit).

Part (1) of this test is satisfied if the group of five or fewer persons as a whole owns at least 80 percent of the voting stock or value of shares of each corporation, regardless of the size of the individual holdings of each person. Thus, for example, part (1) (but not necessarily part (2)) is met whether one person owns 80 percent of the voting stock of each corporation, four persons each own 20 percent of the voting stock of each corporation, or one person owns 60 percent of the voting stock of one corporation and 40 percent of another, and another person owns 40 percent of the voting stock of the first and 60 percent of the second.

Part (2) of the test is satisfied only if the same five or fewer persons own more than 50 percent of the voting stock or value of shares of each corporation, considering stock owned by a particular person only to the extent that it is owned identically in each of the corporations. Thus, for example, a person who owns 80 percent of the voting stock of one corporation and 30 percent of another would be considered as owning 30 percent of both corporations for purposes of part (2) of the test.

The following two examples illustrate the operation of this two-part test:

Example 1

	Percent of stock Ownership (pt. 1)		Percent of Identical Ownership (pt. 2)	
	Corp. No. 1	Corp. No. 2	Corp. No. 1	Corp. No. 2
Shareholders:				
A	30	75	30	30
B	70	25	25	25
Total	100	100	55	55

Example 2

	Percent of stock Ownership (pt. 1)		Percent of Identical Ownership (pt. 2)	
	Corp. No. 1	Corp. No. 2	Corp. No. 1	Corp. No. 2
Shareholders:				
A	80	20	20	20
B	20	80	20	20
Total	100	100	40	40

In both examples, individuals A and B together own 100 percent of both corporations. Thus, part (1) of the test is met. However, under part (2) of the test, the stock holdings of A and B are restricted to the lowest percentage of any member to be included in the group. Thus, in Example 1, because stockholder A owns only 30 percent of Corporation No. 1 he is considered to own only 30 percent of Corporation No. 2. Part (2) of the test is satisfied in Example 1, but not in Example 2. Consequently, the corporations in Example 1 would constitute a brother-sister controlled group while those in Example 2 would not.

* * * * *

(2) *Brother-sister groups.*—A group of corporations in which five or fewer persons[10a] own, to a large extent in identical proportions, at least 80 percent of the stock of each of the corporations. This provision expands present law by considering the combined stock ownership of five individuals, rather than one individual, in applying the 80-percent test. Even the mild 6-percent penalty under existing law for brother-sister corporations claiming multiple surtax exemptions is largely ineffectual because of the present requirement that one person own 80 percent of the stock of each corporation before the group of corporations is subject to the penalty.

However, in order to insure that this expanded definition of brother-sister controlled group applies only to those cases where five or fewer individuals hold their 80 percent in a way which allows them to operate the corporations as one economic entity, the proposal would add an additional rule that the ownership of the five or fewer individuals must constitute more than 50 percent of the stock of each corporation considering, in this test of ownership, stock of a particular person only to the extent that it is owned identically with respect to each corporation.

Thus, even where the 80 percent ownership test is met, the brother-sister definition will not apply unless the stockholdings of the individuals in the various corporations also meet the 50-percent identical ownership test.

[10a] "Persons" in this discussion refers to individuals, estates, or trusts.

For example, if A owns 55 percent of Corporation Y and 45 percent of Corporation Z, and B owns 35 percent of Y and 40 percent of Z, the two tests would apply as follows:

	Percent of stock ownership		Percent of identical ownership	
	Corporation		Corporation	
	Y	Z	Y	Z
Shareholder:				
A	55	45	45	45
B	35	40	35	35
Total	90	85	80	80

As the table illustrates, A and B together own 90 percent of Y and 85 percent of Z. Thus, the basic 80 percent ownership test is met. However, since A owns 55 percent of Y but only 45 percent of Z, his stockholdings in the two are identical only to the extent of 45 percent. Similarly, B's stockholdings are identical only to the extent of 35 percent. Together A and B hold 80 percent each of Y and Z and the 50-percent test is met. Thus, in this example, Y and Z are members of a brother-sister controlled group.

Expanding the 80-percent ownership test from one person to five will close the present opportunity for easy avoidance of that 80-percent test. However, adding the 50-percent identical ownership test will insure that the new expanded definition is limited to cases where the brother-sister corporations are, in fact, controlled by the group of stockholders as one economic enterprise.

After having read the entire Treasury explanation, we fail to understand how this document has been construed as supporting, or at least not contradicting, the

interpretation of section 1563(a)(2) made by Treas. Reg. § 1.1563-1(a)(3). Nevertheless, various courts have construed it in this manner.[10] Therefore, we will discuss in detail how the Treasury explanation clearly indicates that each of the five or fewer persons considered under the 80-percent test must hold some stock in each corporation in the controlled group.

First, and foremost, the Treasury explanation directly states this very proposition:

> * * * Under the proposal, the present definition would be changed so that a group of corporations would constitute a brother-sister controlled group if (1) the *same five* or fewer persons own at least 80 percent of the voting stock or value of shares of *each* corporation, and (2) *these* five or fewer individuals own more than 50 percent of the voting power or value of shares of *each* corporation considering a particular person's stock only to the extent that it is owned identically with respect to each corporation. [Emphasis added in part.]

The use of the word "same" in the above sentence removes any possible ambiguity and establishes that the same persons must own some stock in each corporation. Moreover, the use of the words "these five or fewer individuals" supports the construction of the statute by the Tax Court in *Fairfax Auto Parts* to the effect that the same persons, with no additions or subtractions, must be considered in both the 80-percent and the 50-percent tests.[11]

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[10] *See Allen Oil Co.* v. *Commissioner*, *supra*, 614 F.2d at 339; *T. L. Hunt, Inc.* v. *Commissioner*, *supra*, 562 F.2d at 535; *Fairfax Auto Parts of Northern Virginia, Inc.* v. *Commissioner*, *supra*, 65 T.C. at 809-10 (dissenting opinion), 548 F.2d at 503.

[11] Similar language is also found in H. REP. No. 91-413 and S. REP. No. 91-552, *supra* note 9, with respect to the amendment

Second, if the regulation's interpretation of section 1563(a)(2) is correct, the most significant change made to that section is not the expansion of the number of stockholders considered from one to five but rather the removal of the requirement in the prior version of the 80-percent test that each stockholder must own some stock in each corporation. In effect, the amended section as interpreted by the regulation would reduce the required overlap of ownership from 80 to 50 percent. Yet, the Treasury explanation says only that present law is expanded "by considering the combined stock ownership of five individuals, rather than one individual, in applying the 80-percent test." To paraphrase Judge Webster's dissent in *T.L. Hunt, Inc.* v. *Commissioner*, *supra*, 562 F.2d at 537, the prior version of the 80-percent test required both sameness and smallness. The Treasury explanation indicates that the number constituting smallness would be increased, but there is absolutely no indication that the requirement of sameness would be removed.

Moreover, if the Treasury was indeed proposing to remove the requirement of sameness in the 80-percent test, it is scarcely credible that an example to illustrate this important change would not have been given. In every example in the Treasury explanation involving the 80-percent test, the persons mentioned own some stock in each corporation.[12] The explanation

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of section 1563(a)(2) and in H. REP. No. 749 and S. REP. No. 830, *supra*, with respect to the enactment of section 1551(b)(2).

[12] No examples are provided in the committee reports on the amendment of section 1563(a)(2). However, the example in the House committee report on the original enactment of the same statutory language as section 1551(b)(2) involves persons who own stock in each corporation. H. REP. No. 749, *supra*, [1964] U.S. CODE CONG. & AD. NEWS at 1638-39, 1964-1 C.B. (Part 2) at 460-61.

even states in detail that the 80-percent test is met "whether one person owns 80 percent of the voting stock of each corporation, four persons *each* own 20 percent of the voting stock of *each* corporation, or one person owns 60 percent of the voting stock of one corporation *and 40 percent of another*, and another person owns 40 percent of the voting stock of the first *and 60 percent of the second*." [Emphasis supplied.]

Third, the Treasury explanation indicates in several ways that the 80-percent test was envisioned as a test of independent significance, in fact a test of greater significance than the 50-percent test. The explanation states in two places that the 50-percent test is added to "insure" that the corporations are in fact "controlled" by the group of stockholders as one economic entity or enterprise. The use of the word "insure" indicates that the 80-percent test also measures to some degree whether the corporations can be considered one economic entity. The 80-percent test therefore must measure substantial overlapping financial interests. The 50-percent test was added to "insure," not to establish, the unity of economic enterprise by measuring whether overlapping control exists.

Similarly, the explanation states: "Thus, even where the 80 percent ownership test is met, the brother-sister definition will not apply unless the stockholdings of the individuals in the various corporations also meet the 50-percent identical ownership test." The emphasis of the sentence on the 80-percent test as the primary requirement belies the notion that the 80-percent test was intended to measure only the number of stockholders and not the extent of overlapping stock ownership. The Treasury explanation is totally inconsistent with the relatively minor role relegated to the 80-percent test by Treas. Reg. § 1.1563-1(a)(3).

In conclusion, we find no ambiguity whatsoever in the Treasury explanation and other legislative material when they are read in their entirety. It would be a gross usurpation of the power of Congress to draft tax statutes to allow the Treasury to explain a legislative proposal in one way and then to interpret it after enactment in a far more expansive fashion. Since it was understood at all times during the legislative consideration of the Tax Reform Act of 1969 that the proposal would track the language of section 1551(b)(2), there can be no doubt that Congress was enacting precisely what it understood the Treasury to be proposing.

V

Defendant relies upon two similar arguments to support its interpretation of section 1563(a)(2). First, since section 1563(a)(2) of the Code (section 401(c) of the Tax Reform Act of 1969, *supra*) contains language identical to the previously enacted section 1551(b)(2), Congress must have intended to adopt the interpretation of this language made in Treas. Reg. § 1.1551-1 (1967). Second, the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, §§ 1013(c)(1) and 1015, 88 Stat. 921, 925, incorporated section 1563(a) by reference in sections 404(a)(1)(C) and 414(b) of the Internal Revenue Code at a time when Treas. Reg. § 1.1563-1(a)(3) had already been published. Therefore, defendant argues that Congress necessarily approved the interpretation of section 1563(a)(2) made by the regulation.

While it is clear that Congress intended the same statutory tests to be applied in all of the above instances, there is no indication in the legislative history of either the Tax Reform Act of 1969 or ERISA that

Congress was aware of or approved any regulation interpreting the control requirements for the brother-sister corporations. According to 1 MERTENS' LAW OF FEDERAL INCOME TAXATION ¶ 3.24 (1974 rev. ed.), the rule relating to implied congressional approval of an administrative construction through statutory reenactment is an anachronism left over from earlier days in which statutes were briefer, were seldom reenacted or amended, and where administrative interpretation was far simpler. Reenactment—particularly without the slightest affirmative indication that Congress ever had before it the particular construction in question—is an unreliable indicium at best. *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

In addition to the general unreliability of the doctrine of statutory reenactment, the doctrine has been found particularly inappropriate where the prior construction is not of long standing. In *United States* v. *Calamaro*, 354 U.S. 351, 358-59 (1957), the Supreme Court refused to give any significance to the reenactment of a provision as a part of the 1954 Code only 3 years after the issuance of the regulation in question. *Accord*, *Commissioner* v. *Sun Pipe Line Co.*, 126 F.2d 888, 892 (3d Cir. 1942); *Commissioner* v. *F.H.E. Oil Co.*, 102 F.2d 596, 598 (5th Cir. 1939), *aff'd*, 308 U.S. 104 (1939); *see also Eastman Kodak Co.* v. *United States*, 99 Ct. Cl. 569, 572, 48 F.Supp. 357, 359 (1943). Because of the short periods between the publication of each regulation and the enactment of the subsequent statute (22 months in the case of the regulations under section 1551(b)(2) and 29 months in the case of Treas. Reg. § 1.1563-1(a)(3)), congressional approval of the regulations cannot be implied.

Finally, defendant's first argument must also be rejected because the regulations under section 1551(b)(2)

did not unambiguously establish the interpretation which, according to defendant, Congress approved. Any implied congressional approval must necessarily be limited to the literal wording of the regulations and cannot be extended to a possible inference or interpretation. *Montana Power Co.* v. *United States*, 232 F.2d 541, 549 (3d Cir.), *cert. denied*, 352 U.S. 843 (1956). In drafting Treas. Reg. § 1.1551-1, the Treasury did not add the words "singly or in combination" to the statutory language as it did to the same language in Treas. Reg. § 1.1563-1(a)(3). Furthermore, the Treasury did not provide an explicit example such as Treas. Reg. § 1.1563-1(a)(3)(ii), Example (1), to show that persons owning stock in only one corporation can be counted in the 80-percent test. The examples provided in Treas. Reg. § 1.1551-1 are capable of more than one interpretation.

One example, Treas. Reg. § 1.1551-1(f)(2), Example (2), involves individual A who owns all of the stock of corporation X. Individual A transfers property to corporation Y in exchange for 60 percent of the voting stock of Y. During a later taxable year of Y, A acquires an additional 20 percent of Y's voting stock. The example concludes that section 1551(a)(3) is applicable *beginning in the taxable year in which the later acquisition of stock occurred*. The inapplicability of section 1551(a)(3) to the earlier taxable years can only be explained in one of two ways. First, the Treasury then considered that the 80-percent test would only apply to persons who owned stock in both X and Y. Alternatively, the 40 percent of Y's stock not owned previously by A could have been so diversely held that no four other stockholders would own as much as 20 percent. This alternative explanation is unlikely because it assumes that the drafters of the regulation committed a cardinal error in writing an example by failing

to provide all of the facts necessary to understand the example.

Another example, Treas. Reg. § 1.1551-1(g)(4), Example (4), on which defendant relies, may indicate a contrary proposition. In this example, individual A owns 55 percent of the stock of corporation X. Another 25 percent of the stock of X is owned in the aggregate by individuals B, C, D, and E. Individual A transfers property to corporation Y in exchange for 60 percent of the stock of Y, and B, C, and D acquire all of the remaining stock of Y. The example concludes, without providing any rationale, that the transfer is within the scope of section 1551(a)(3). Defendant argues that the example demonstrates that owning stock in both corporations is not a requirement of the 80-percent test. However, the examples under paragraph (g) of Treas. Reg. § 1.1551-1 are intended as illustrations of the nature of the transfer required under that paragraph rather than as illustrations of the meaning and application of the term "control" discussed in paragraph (e). It has been suggested that the example merely illustrates that a transfer can be made by one, rather than all, of the individuals in control of the transferor corporation or that the controlling stockholders of the transferee corporation must come from the group of five or fewer stockholders of the transferor but need not include all of the members of that group. Bonovitz, *Brother-Sister Controlled Groups under Section 1563: The 80 Percent Ownership Test*, 28 TAX LAWYER 511, 524-28 (1975). These suggested constructions of the example would not conflict with our interpretation of section 1563(a)(2) and are just as likely to be the proper construction of an ambiguous example as that of defendant's.

Thus, we hold that no definite conclusions with respect to the proper interpretation of section 1563(a)(2)

can be drawn from the regulations under section 1551(b)(2) or from the later enactment of ERISA.

VI

In addition to concluding that Treas. Reg. § 1.1563-1(a)(3) is inconsistent with Congress' intent as evidenced by the legislative history, we have further determined that the regulation is an unreasonable interpretation of the statute. Under the regulation, the 80-percent test measures nothing of significance when the purpose of the statute is considered.

The purpose of the tests in section 1563(a)(2) is to measure whether there is such a substantial identity between the stockholdings of two or more corporations to warrant treating them as one entity limited to one surtax exemption.[13] The percentage of overlapping stockholdings that constitutes such a substantial identity is necessarily a somewhat arbitrary figure.[14] Con-

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[13] The same tests of control also affect the amounts allowed in computing the accumulated earnings credit under section 535(c)(2) and (3) of the Code and the limitation on the small business deduction of life insurance companies under sections 804(a)(3) and 809(d)(10). *See* section 1561(a)(2) and (3). As discussed in part V of this opinion, *supra*, the same definition of the term "controlled group" is adopted with respect to pension and profit-sharing plans in sections 404(a)(1)(C) and 414(b) of the Code by ERISA. Other cross-references in the Code to section 1563(a) are found in section 46(a)(6) relating to the $25,000 refund limitation on the investment tax credit, in section 58(b) relating to the $10,000 exemption from the minimum tax on preference items, and in section 179(d)(6) relating to the $10,000 limitation on additional first-year depreciation for small business.

[14] Thus, even if one person owns 100 percent of the stock of one corporation and 79.9 percent of the stock of a second corporation, the two corporations would not be a controlled group. While this may seem to some to permit abusive situations, it is

gress could, if it wished to do so, set the minimum percentage of overlap at 50 percent, but if it did, it would not have included a superfluous 80-percent test. As Judge Webster states in his dissenting opinion in *T. L. Hunt, Inc.* v. *Commissioner*, *supra*, 562 F.2d at 537:

> * * * There is nothing in the legislative history to suggest that Congress intended to penalize companies in which there were five or fewer shareholders. It is not the *smallness* of the number of persons in each company that triggers § 1563; it is the *sameness* of that small number. The 80 percent financial interest requirement is meaningless unless it is the *same* group of five or fewer persons that own 80 percent of each company within the controlled group. It is this requirement of "economic entity" which is entirely eviscerated by Reg. § 1.1563–1(a)(3). [Emphasis in original.]

Futhermore, section 1563(a)(1) provides persuasive evidence that Congress would require a significantly greater overlap of stockholdings than 50 percent before it would treat two or more corporations as one entity. Section 1563(a)(1) defines a "parent-subsidiary controlled group" as existing where a parent corporation owns stock representing 80 percent of the value or voting power of one or more subsidiary corporations either directly or indirectly through a subsidiary. It seem unlikely that Congress would require a lesser identity of ownership between brother-sister corpora-

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unquestionably Congress' prerogative to choose the determinative percentage, and in this case, it has choosen 80 percent. It is certainly no more arbitrary to classify these two corporations as not constituting a controlled group than it would be to hold under the regulation that they were a controlled group even if the stock held in the second corporation were only 50.1 percent.

tions owned by up to five persons than between a more centralized and more easily controlled parent-subsidiary group.

The Second Circuit in *Allen Oil Co.* v. *Commissioner, supra*, 614 F.2d at 340, has offered the following explanation of the 80-percent test as interpreted by Treas. Reg. § 1.1563-1(a)(3):

> * * * According to the Commissioner, the 80% test is designed to assure that within the group of five persons or fewer the overall control of or financial interest in each of the corporations will beyond question be substantially more than 50% (i.e., 80%), * * *
>
> * * * it [the 80-percent test as interpreted by the Commissioner] insures that the stock is closely held. Thus, even though five or fewer persons may satisfy the 50% control test, the tax exemption of a corporate member of the group is saved only if shareholders who are not part of the group of five or fewer own more than 20% of its stock.

The majority opinion in *T.L. Hunt, Inc.* v. *Commissioner, supra*, 562 F.2d at 536 n.2, similarly states:

> * * * The 80 percent test prevents the denial of surtax exemptions in situations meeting the 50 percent control test if five or fewer persons do not meet the 80 percent financial interest test. The 80 percent test thus serves the purpose of saving the tax exemption in situations where minority stockholders own a substantial amount of the stock.

These explanations are only a restatement of the obvious implications of defendant's interpretation of the 80-percent test. Indeed, it does measure whether 80 percent of the stock of each corporation is closely held and conversely whether many small stockholders together own a substantial amount of stock, but no ex-

planation is offered why these facts have any significance to the question of whether the corporations are "one economic entity." No one has provided any rationale for including in the number of stockholders counted in the 80-percent test those stockholders who only own stock in one of the corporations.

We do not believe that any reasonable purpose is served by counting such persons. For example, suppose that individual A owns 100 percent of the stock of corporation X and 60 percent of the stock of corporation Y, that individuals B,C,D, and E (first group) each own 5 percent of the stock of Y for a total of 20 percent, and that individuals F,G,H,I, and J (second group) each own 4 percent of the stock of Y for a total of 20 percent. Individual A owns in excess of 50 percent of each corporation and therefore has undisputed voting control of both. While we would hold that the 80-percent test was not met, defendant would maintain that it would be met because the stock of the first group could be added to A's stock. We disagree because the members of the first group have nothing in common with A which could logically cause them to be included with A in a group of controlling stockholders for the purpose of limiting the surtax exemptions of X and Y. The interests of the first group are virtually identical to those of the second group. They will suffer the same as the second group if Y's surtax exemption is lost, and since they do not hold stock in X, they will have done nothing more than the second group to trigger such treatment of Y except for the ownership of slightly more stock in Y.

While the above example represents an extreme case clearly demonstrating the unreasonableness of defendant's position, we believe that the same principles would hold true if B owned 24 percent of the stock of Y and stockholders C through J each owned 2 per-

cent for a total of 16 percent. B would still have more in common with the 2-percent stockholders than with A. B would be just as much a "minority stockholder" as they are.[15]

Finally, defendant points out that if Richard Crain held as much as one share of stock in Vogel Popcorn, then section 1563(a)(2) would apply even under our interpretation. Defendant contends that had Congress intended to require common ownership as part of the 80-percent test, it would have provided for some minimum and meaningful level thereof and would not have left it to turn upon the happenstance of a symbolic but factually meaningless ownership of a single share. Defendant's argument may seem valid in the

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[15] The dissent suggests that the purpose of the 80-percent test under the position taken by the regulation is to insure that the stockholders with overlapping 50-percent control of both corporations can obtain 66⅔-percent or 75-percent voting control when necessary without experiencing the difficulty and attendant delay of dealing with a large number of other stockholders. There is absolutely nothing in the legislative history to suggest that the 80-percent test was intended to measure control. For the most part, the operation of two or more corporations as one economic entity can be secured by mere 50-percent control. In enacting the 80-percent test, Congress obviously had in mind something other than control. Eighty-percent ownership was made relevant as a test of a substantial *identity* of financial interest between the two corporations.

Moreover, assuming *arguendo* that the 80-percent test is a "control" test, control would be relevant only to the extent that it would allow the two or more corporations to be operated as one entity. The stockholders with overlapping 50-percent control of both corporations would not be able to secure the agreement of a stockholder in only one of the corporations to a proposal that would be disadvantageous to his corporation. It is not "control" if the majority stockholders have to negotiate with, and make concessions to, the minority stockholders in order to pass a proposal.

abstract but it has no merit when the predictable actions of real taxpayers are considered. It might well be appropriate not to consider the ownership of a token amount of stock if taxes could be *avoided* by such ownership. Here the ownership of a token amount of stock would *increase* taxes, and Richard Crain would be most ill advised to acquire one share of stock in Vogel Popcorn and so cause the 80-percent test to be satisfied. Presumably, Mr. Crain is aware of the tax laws and would only acquire stock in Vogel Popcorn if he wished to make an investment of sufficient magnitude to compensate for the loss of a surtax exemption.

VII

Normally courts are reluctant to invalidate a Treasury Regulation and will do so only if the regulation clearly constitutes an impermissible expansion or contraction of the provision of the Internal Revenue Code that it interprets and applies. The courts recognize the broad discretion of the Commissioner by regulation to give detailed content to, fill in the details of, and explain and define the various provisions of, the Code. *See, e.g., Bingler* v. *Johnson*, 394 U.S. 741, 749–50 (1969); *United States* v. *Correll*, 389 U.S. 299, 305–06 (1967). If the meaning or application of the Code provision is unclear, the regulation ordinarily carries the day.

The present case, however, is inappropriate for the application of that principle, upon which the dissenting opinion in the Tax Court in *Fairfax* placed great weight. 65 T.C. at 807–08. The sole question here is whether the 80-percent provision requires that the five or fewer persons involved each hold stock in all of the brother-sister corporations. The answer to that ques-

tion turns upon the statutory language, the legislative history, and the basic purpose and design of the legislation.

If section 1563(a)(2)(B) applies only when each of the stockholders holds stock in each of the corporations, then the regulation is invalid as an impermissible alteration of the statute. If, on the other hand, the 80-percent provision applies even where each of the persons does not hold stock in each of the corporations, that conclusion flows from the statute itself, without regard to the regulation. In this case, therefore, the regulation either adds nothing not already in the statute or is inconsistent with the statute. Accordingly, the regulation here is not entitled to the significance we otherwise would give it.

Conclusion

Accordingly, we hold Treas. Reg. § 1.1563-1(a)(3) invalid to the extent that it counts stock held by a shareholder in only one corporation of the group of corporations toward the 80-percent requirement in section 1563(a)(2)(A). Plaintiff's cross-motion for summary judgment is granted, and defendant's motion for summary judgment is denied. The case is remanded to the trial division for a determination under Rule 131(c) of the amount of plaintiff's recovery.

FRIEDMAN, *Chief Judge*, concurring:

Although I fully agree with everything in the court's opinion, I add the following comments:

As noted, in the 1964 statute a "brother-sister controlled group" was defined as two or more corporations in which a single individual owned 80 percent or more

of the stock. Under that definition no question could arise whether the same individual had to be a stockholder in all of the brother-sister controlled corporations.

When Congress in 1969 expanded the definition of brother-sister controlled corporations to cover situations where up to five people owned 80 percent of the stock, it is reasonable to assume that it intended to build on the previous law, changing only the number of persons whose stock interests would be considered and not the nature of those interests. If, when Congress broadened the number of persons from one to five, it also intended to make the definition applicable even where not all of those additional stockholders held interests in all of the corporations, presumably it would have explicitly so indicated—either in the language of the statute or in its legislative history. It did neither. Not only does the legislative history fail so to indicate, but, as shown, whatever history there is on this issue points in the opposite direction.

The defendant argues, however, that in the 50-percent provision Congress has manifested its intention to change the character of the interlocking interests. The argument is that since only the latter provision contains language specifically recognizing that the five or fewer stockholders must have stock in all of the companies, the implication is that the 80-percent provision, which does not contain similar language, does not include that requirement.

The language of the 50-percent provision upon which the defendant relies, however, does not justify that inference. It states that in determining whether five or fewer persons own 50 percent of the stock, the stock ownership of each such person is to be considered "only to the extent such stock ownership is identical

with respect to each such corporation." The purpose of this requirement is to insure that the same five or fewer individuals together control (by ownership of a majority of the stock) each of the brother-sister corporations. The situation to which this provision is addressed is illustrated in footnote 3 of the court's opinion: one person owns 80 percent of the stock in corporation A and 20 percent of the stock in corporation B, a second person owns 80 percent of corporation B and and 20 percent of corporation A. Although the 80-percent test would be met, there would be no common control. The 50-percent test was necessary to prevent the two corporations in that situation from being treated as under common control.

The congressional requirement that each member of the control group must have an interest in each of the corporations, and that the members of the group together must have more than 50 percent of the stock of each corporation, cannot fairly be read as indicating a congressional intent to permit the 80-percent test to be applied to different groups of five or fewer stockholders whose only common bond is that together the stockholders in each group own as least 80 percent of the stock in their particular corporation.

SMITH, *Judge*, dissenting:

That Treas. Reg. § 1.1563-1(a)(3)(1972) must be sustained unless it is "unreasonable and plainly inconsistent with" I.R.C. § 1563(a)(2) is incontrovertible.[1]

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[1] *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948). Hence, the issue in this case is not whether the majority's interpretation of section 1563(a)(2) is more reasonable than the interpretation espoused by the regulation; the issue is whether the regulation is *a* reasonable interpretation of the statute.

The majority admits that the interpretation of section 1563(a)(2) espoused by the regulation "is not wholly unreasonable as a construction of the words appearing in" the statute. Moreover, the majority acknowledges that "[t]he statute itself has been *fairly* criticized as being open to at least four different constructions." (Emphasis added.) Hence, the majority appears to concede that the regulation is not plainly inconsistent with the text of the statute. The majority believes, however, that the regulation is "clearly inconsistent with the legislative history [of the statute] and unreasonable when the purpose as well as the bare words, of the statute are considered."

The "legislative history" which the majority has in mind consists not of congressional committee reports but of the two explanations prepared by the Treasury Department to accompany its 1969 proposal to Congress that section 1563(a)(2) be amended.[2] The majority derives its holding that the regulation is invalid almost exclusively from its reading of these explanation. Hence, assuming that the Treasury explanations are more than a possible admission against interest, and can be regarded as persuasive evidence of what Congress intended the amended section 1563(a)(2) to mean, the test of whether the majority is correct can be stated as follows: Is the regulation plainly inconsistent with the meaning of the statute as that meaning has been clarified by the Treasury explanations?

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[2] TECHNICAL EXPLANATION and GENERAL EXPLANATION OF TREASURY TAX REFORM PROPOSALS, *Hearings Before the House Comm. on Ways and Means on Tax Reform*, 91st Cong., 1st Sess. 5168-70, 5394-96 (1969). It is recalled that Congress enacted without change, as part of the Tax Reform Act of 1969, the amendment of section 1563(a)(2) proposed by the Treasury Department.

I have read the Treasury explanations carefully. I cannot say that they are contradicted by the regulation.[3] Indeed, they can reasonably be read as supportive of the regulation. That being the case, the issue is not whether plaintiff's interpretation is *as* reasonable as defendant's; clearly that will be true in certain given factual situations. The issue is whether plaintiff has carried its heavy burden of showing the regulation to be unreasonable and plainly inconsistent with the statute. This plaintiff cannot do or at least has not done.

The regulation interprets the 80-percent test in section 1563(a)(2)(A) to mandate only that the same *group* of five or fewer persons own 80 percent of the stock of each corporation. In other words, the regulation interprets the 80-percent test not to require that each member of the group have a stock interest in each corporation.[4] Support for the regulation's interpretation of the 80-percent test can be found in both of the Treasury explanations. The Technical Explanation states:

> Part (1) of this test [namely, section 1563(a)(2)(A)] is satisfied *if the group* of five or fewer persons *as a whole* owns at least 80 percent of the voting stock or value of shares of each corporation, *regardless of the size of the individual holdings of each person*. Thus, for example, part (1) (*but not necessarily part (2)* [the 50-percent identical ownership requirement of section 1563(a)(2)(B)] is met *whether one person owns 80 percent of the voting stock of each corporation*, four persons each own 20 percent of the voting stock of each corporation,* * * [Emphasis added.]

[3] In *Allen Oil Co.* v. *Commissioner*, 614 F.2d 336 (2d Cir. 1980), the second circuit reached the same conclusion.

[4] The regulation is consistent with the text of section 1563(a)(2)(A). Nothing in the text thereof can be read to require

The General Explanation states:

> Expanding the 80-percent ownership test from one person to five will close the present opportunity for easy avoidance of that 80-percent test. However, adding the 50-percent identical ownership test will insure that the new expanded definition is limited to cases where the brother-sister corporations are, in fact, controlled *by the group* of stockholders as one economic enterprise. [Emphasis added.]

The quoted portions of the Treasury explanations suggest a reading of the explanations which is both reasonable and harmonious with the regulation. The suggested reading is as follows. The amendment of section 1563(a)(2) was intended, with respect to the 80-percent test, to expand the reference point of voting control or financial interest from the same single person to the same *group* of five or fewer persons. As long as the same group of five or fewer persons possessed 80 percent voting control of or financial interest in each corporation, the 80-percent test would be satisfied regardless of whether each member of the group had an interest in each corporation. However, to insure that there would be adequate *common* ownership of all the corporations, the more than 50 percent identical ownership requirement was added. Its effect would be (a) to insure that one or more members of the group would be shareholders of *all* the corporations and (b) to insure that these members' aggregate identical stock interests in all the corporations would represent greater than 50 percent voting control of or financial interest in each of the corporations.[5]

that each member of the group have an interest in each corporation.

[5] Greater than 50 percent voting control provides, generally speaking, the power to determine everyday corporate activities.

Under this reading of the Treasury explanations, the 80-percent test and the more-than-50-percent test each have an independent significance. The more-than-50-percent test insures that everyday control of all the corporations emanates from the same source, *i.e.*, from the same shareholder or shareholders who have a greater than 50 percent stock interest in all the corporations. The 80-percent test insures that, in those instances where a greater interest, as, for example, 66⅔ percent or 75 percent voting control or financial interest, is needed, the more-than-50-percent shareholder control group can obtain this additional necessary voting control or financial interest without experiencing the difficulty and attendant delay of dealing with a large number of other shareholders.[6]

Even though a reasonable person can read the Treasury explanations to impute the just described meaning to the 80-percent and more-than-50-percent tests and even though this meaning is the meaning of the tests which is espoused by the regulation, the majority holds the regulation invalid. The majority interprets section 1563(a)(2) to require that each shareholder counted in applying the 80-percent test have a stock interest in each corporation. According to the majority, the stock interest is not required to be any specific minimum amount. Hence, the ownership of 1 share in a corporation would, as to that corporation and as to the shareholder owning that 1 share, satisfy the requirement.

The majority's requirement gives rise in the instant case to a result which is inconsistent with the purpose

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[6] The 80-percent test insures, in short, that all the corporations are closely held. Their being closely held is important because it facilitates their operation as a unified economic enterprise.

underlying section 1563(a)(2). Arthur Vogel owned during the tax years in question 77.49 percent of the only class of stock of Vogel Fertilizer Company. During the same years, his stock in Vogel Popcorn Company provided him with 87.5 percent voting control of that corporation. Hence, using his stock alone, he could muster at least 75 percent voting control of both corporations.[7] Possessing this voting control, he had the power to direct the operations of both corporations and to cause the corporations to operate as a unified economic enterprise. Yet the majority holds that the two corporations were not brother-sister and, hence, were each entitled to a full surtax exemption.

The majority's requirement will give rise in other situations to equally unreasonable and inconsistent results. Consider, for example, the situation in which X owns 100 percent of the stock of corporation A and 79.9 percent of the only class of stock of corporation B. The remaining 20.1 percent of the stock of B is owned by Y. Under the majority's interpretation of section 1563(a)(2), A and B are not brother-sister corporations because the 80-percent test is failed.[8] However, if this example is changed merely by having X own all the stock of A except 1 share and having Y own this 1 share, A and B are brother-sister corporations even under the majority's interpretation of section 1563(a)(2).

There is absolutely no rational basis for differentiating the treatment to be accorded to A and B in

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[7] If he were to need 80 percent voting control of Vogel Fertilizer Company, he could negotiate with a single shareholder, Richard Crain, for the additional necessary voting power.

[8] Yet, using merely his stock, X has 75 percent voting control of both corporations and, hence, can cause the corporations to operate as a unified economic enterprise.

the second example from the treatment to be accorded to them in the first example.[9] Yet this is precisely what the majority's interpretation does. I realize, of course, that section 1563(a)(2) is a mechanical test, but unfortunately the proof does not exist that Congress intended the mechanical test which the majority has in mind and which leads to the unreasonable results just described.

Therefore, I respectfully dissent.

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[9] In both examples, the fact that A and B can be operated as a single economic enterprise is attributable to the stockholdings of X, not to those of Y. Thus, Y's 1 share in A in the second example should not be significant.

APPENDIX B

In The United States Court Of Claims

No. 69-78

VOGEL FERTILIZER COMPANY

v.

THE UNITED STATES

[Filed Oct. 3, 1980]

Before FRIEDMAN, *Chief Judge*, BENNETT and SMITH, *Judges*.

ORDER

This case comes before the court on defendant's motion, filed September 12, 1980, for rehearing *en banc* pursuant to Rules 7 (d) and 151 (b) with reference to the decision entered herein on August 13, 1980. Upon consideration thereof, together with the response in opposition thereto, without oral argument, by the six active Judges of the court (Judge Davis not participating therein) as to the suggestion for reharing *en banc* under Rule 7 (d), which suggestion is denied, and further having been so considered by the panel listed above as to the motion for rehearing under Rule 151 (b),

IT IS ORDERED that defendant's said motion for rehearing be and the same is denied.

BY THE COURT

DANIEL M. FRIEDMAN
Chief Judge

APPENDIX C

In the United States Court of Claims

No. 69-78

VOGEL FERTILIZER COMPANY

v.

THE UNITED STATES

[Filed Nov. 28, 1980]

ORDER

On August 13, 1980, the court issued an opinion holding that the plaintiff was entitled to recover and entered judgment to that effect. Determination of the amount of recovery was reserved pending further proceedings under Rule 131(c).

On November 24, 1980, the trial judge of this court filed a memorandum report, herein adopted by the court, recommending that, in accordance with the opinion of the court and a stipulation of the parties, judgment be entered for plaintiff for the successive tax years ending November 30, 1973, 1974, and 1975, in the respective amounts of $4,000, $4,834, and $12,905, together with interest as allowed by law.

IT IS THEREFORE ORDERED that judgment be and the same is entered for the plaintiff, for the tax years ending November 30, 1973, 1974, and 1975, the respective sums of four thousand dollars ($4,000); four thousand eight hundred thirty-four dollars ($4,834); and twelve thousand nine hundred five dollars ($12,905), together with interest on these amounts as allowed by law.

BY THE COURT

/s/

DANIEL M. FRIEDMAN
Chief Judge

APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 11 [as amended by Revenue Act of 1964, Pub. L. No. 88-272, Section 121, 78 Stat. 25, and Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(b)(2)(B), 83 Stat. 602]. TAX IMPOSED.

* * * * *

(d) *Surtax Exemption*.—For purposes of this subtitle, the surtax exemption for any taxable year is * * *, except that, with respect to a corporation to which section 1561 or 1564 (relating to surtax exemptions in case of certain controlled corporations) applies for the taxable year, the surtax exemption for the taxable year is the amount determined under such section.

* * * * *

SEC. 1561 [as added by Revenue Act of 1964, Pub. L. No. 88-272, Section 235 (a), 78 Stat. 116, and amended by Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401 (a)(1), 83 Stat. 599]. LIMITATIONS ON CERTAIN MULTIPLE TAX BENEFITS IN THE CASE OF CERTAIN CONTROLLED CORPORATIONS.

(a) *General Rule*.—The component members of a controlled group of corporations on a December 31 shall, for their taxable years which include such December 31, be limited for purposes of this subtitle to—

(1) one * * * surtax exemption under section 11 (d),

(2) one $100,000 amount for purposes of computing the accumulated earnings credit under section 535 (c) (2) and (3), and

(3) one $25,000 amount for purposes of computing the limitation on the small business deduction of life insurance companies under sections 804 (a) (4) and 809 (d) (10).

The amount specified in paragraph (1) shall be divided equally among the component members of such group on such December 31 unless all of such component members consent (at such time and in such manner as the Secretary or his delegate shall by regulations prescribe) to an apportionment plan providing for an unequal allocation of such amount. The amounts specified in paragraphs (2) and (3) shall be divided equally among the component members of such group on such December 31 unless the Secretary or his delegate prescribes regulations permitting an unequal allocation of such amounts.

* * * * *

SEC. 1563 [as added by Revenue Act of 1964, Pub. L. No. 88-272, Section 235 (a), 78 Stat. 120, and amended by Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401 (c), 83 Stat. 602]. DEFINITIONS AND SPECIAL RULES

(a) *Controlled Group of Corporations.* — For purposes of this part, the term "controlled group of corporations" means any group of—

* * * * *

(2) *Brother-Sister-Controlled Group.*—Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing—

(A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and

(B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.

* * * * *

Treasury Regulations on Income Tax (26 C.F.R.):

§ 1.1563-1 *Definition of controlled group of corporations and component members.*

(a) *Controlled group of corporations.*—(1) *In general.* For purposes of sections 1561 through 1563 and the regulations thereunder, the term "controlled group of corporations" means any group of corporations which is either a "parent-subsidiary controlled group" (as defined in subparagraph (2) of this paragraph), a "brother-sister controlled group" (as defined in subparagraph 3 of this paragraph, a "combined group" (as defined in subparagraph (4) of this paragraph), or an "insurance group" (as defined in subparagraph (5) of this

paragraph). For the exclusion of certain stock for purposes of applying the definitions contained in this paragraph, see section 1563 (c) and § 1.1563-2.

* * * * *

(3) *Brother-sister controlled group.* (i) The term "brother-sister controlled group" means two or more corporations if the same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of the rules contained in paragraph (b) of § 1.1563-3) singly or in combination, stock possessing—

* * * * *

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No. 80-1251

In the Supreme Court of the United States

October Term, 1980

UNITED STATES OF AMERICA,
Petitioner,

v.

VOGEL FERTILIZER COMPANY,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR CERTIORARI

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In the Supreme Court of the United States

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UNITED STATES OF AMERICA,
Petitioner.

v.

VOGEL FERTILIZER COMPANY,
Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

The Respondent, Vogel Fertilizer Company, respectfully requests that this Court deny the petition for writ of certiorari seeking review of the United States Court of Claims opinion in this case.

THE QUESTION PRESENTED FOR REVIEW

The question presented for review is simply whether Vogel Fertilizer Company, the Respondent, and Vogel Popcorn Company must be considered as a "brother-sister controlled group" under Section 1563(a)(2) of the Internal Revenue Code of 1954 (26 U.S.C.) for purposes of the corporate surtax exemption under I.R.C. § 1561(a) and § 11(d). The resolution of this question is directly dependent upon whether the Treasury Regulation promulgated by the Government under I.R.C. § 1563 (Treas. Reg. § 1.1563-1(a)(3)) is valid despite its effect of unilaterally expanding the scope of I.R.C. § 1563 beyond that intended by Congress.

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STATEMENT OF THE CASE

For purposes of this particular brief, Respondent accepts most of the Statement of the Case made in the Petition. See Petitioner's Brief for Certiorari at pp. 1-5. However, the following additional factual points should be made:

1. For purposes of this case, the stock held by either Richard Crain and Arthur Vogel cannot be attributed to the other under the attribution rules of I.R.C. § 1563(d). Furthermore, Arthur Vogel cannot be considered the constructive owner of the shares in Vogel Popcorn Company held by him as Trustee. (Petitioner's Brief for Certiorari at 2a).

2. Petitioner has asserted as part of the factual foundation of this case that Respondent has "conceded that the governing Regulations (Section 1.1563-1(a)(3)(ii)) explicitly provided that 'the five or fewer persons' can own 80% of the stock of each corporation, singly or in combination, and included an example corresponding exactly to this case." Petitioner's Brief for Certiorari at 3. This assertion is too broad, as the Respondent's only concession has been to the effect that if Example (1) of Treas. Reg. § 1.1563-1(a)(3)(ii) is valid, then Richard Crain's stock can be counted toward the requisite 80 percent. Respondent has consistently argued, however, that the Regulation is unreasonable and clearly inconsistent with the statute. (Petitioner's Brief for Certiorari at 6a.)

3. The Court of Claims, after reviewing the available legislative history, found that the Treasury's own explanation of I.R.C. § 1563(a)(2) "clearly indicates that each of the five or fewer persons considered under the 80-percent test must hold some stock in each corporation in the controlled group." Petitioner's Brief for Certiorari at 21a. Therefore, as part of the basis of its opinion, the

Court of Claims noted that "It would be a gross usurpation of the power of Congress to draft tax statutes to allow the Treasury to explain a legislative proposal in one way and then to interpret it after enactment in a far more expansive fashion." (Petitioner's Brief for Certiorari at 24a.)

4. The Court of Claims did recognize the broad discretion in most instances of the Commissioner to prepare regulations giving detailed content to, filling in the details of, and explaining and defining the various provisions of, the Internal Revenue Code. That Court held, however, that the Commissioner here had overstepped his authority by imposing a regulation that was "an impermissible alteration of the statute." (Petitioner's Brief for Certiorari at 34a.)

SUMMARY OF ARGUMENT

The United States Court of Claims is a court of national jurisdiction in matters of federal taxation, unlike the various Circuit Courts of Appeal. The decision below of the Court of Claims correctly recognized that Treas. Reg. § 1.1563-1(a)(3) unjustifiably expanded I.R.C. § 1563 (a)(2) beyond what was intended by the legislature when that statute was enacted. This Court, therefore, need not grant the writ for certiorari on the basis of either error or conflict, as the Government alleges, as denial would cause the Court of Claims decision to be, in effect, the correct and uniform rule on a nationwide basis as to this particular aspect of the administration of the revenue laws. If I.R.C. § 1563(a)(2) then requires further clarification, it should then be the duty of the legislature rather than this Court (or the Government by regulation) to so rewrite I.R.C. § 1563(a)(2).

For these and other reasons, it is respectfully argued that the petition for a writ of certiorari should be denied.

REASONS FOR DENYING THE WRIT OF CERTIORARI

1. The decision entered by the Court of Claims clearly reflects the careful and judicious review by that Court of all of the arguments and authorities raised to this point by the Government in this and the other cases discussing the issue at hand. The Government has been unable to raise any new arguments in its Petition that would, in the opinion of the Respondent, have caused that decision to change. Despite the Government's allegations to the contrary in its brief, the Court of Claims has correctly interpreted the statute in question, and has not made any fundamental error requiring this Court's review. See generally, Petitioner's Brief for Certiorari at 7-13.

Furthermore, the Court of Claims decision has been reinforced by receiving wholesale approval in an opinion written by the Fifth Circuit Court of Appeals, *Delta Metalforming v. Commissioner*, No. 78-3699 (Dec. 8, 1980), on the exact issue herein. It is argued that the Court of Claim's reasoning is most persuasive and sound, and that the issue has been fully considered and correctly decided. It is submitted that even if this Court would see fit to grant the writ of certiorari, it will ultimately come to the same conclusion that Treas. Reg. § 1.1563-1(a)(3) is invalid. The Government, therefore, cannot be found to have carried its burden of establishing error on the part of the Court of Claims, and consequently is not able to establish sufficient justification for the issuance of a writ of certiorari.

2. There is no doubt that the Court of Claims decision below is at odds with decisions previously entered by the Second, Fourth, and Eighth Circuit Courts of Appeal. *See, e.g., Fairfax Auto Parts of Northern Virginia, Inc. v. Commissioner*, 548 F.2d 501 (4th Cir. 1977),

rev'g 65 T.C. 798 (1976), cert. denied, 434 U.S. 904 (1977); *T. L. Hunt, Inc. v. Commissioner*, 562 F.2d 532 (8th Cir. 1977), rev'g 35 T.C.M. 966 (1976); *Allen Oil Co. v. Commissioner*, 614 F.2d 336 (2d Cir. 1980), rev'g 38 T.C.M. 355 (1979). It is important to note, however, that the Court of Claims follows a course first blazed (and still followed) by the Tax Court and recently approved by the Fifth Circuit, all despite the opinions entered by the Second, Fourth, and Eighth Circuits. See the cases cited by the Court of Claims, Petitioner's Brief for Certiorari at 6a-7a; *Delta Metalforming v. Commissioner*, No. 78-3699 (5th Cir., Dec. 8, 1980). Because of the Court of Claims unique status as a court with national jurisdiction in tax matters, however, this difference of opinion need not be considered so serious as to require the expenditure of this Court's precious resources through the grant of a writ of certiorari.

The Court of Claims broad jurisdiction is defined in the Judicial Code as follows:

> "Claims against the United States generally; . . .
>
> "The Court of Claims shall have jurisdiction to render judgment upon any claim against the United States founded either upon the Constitution, or any Act of Congress, or any regulation of an executive department, or upon any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort . . ." 28 U.S.C. § 1491.

Accordingly, tax claims based on the question raised herein may be brought to the Court of Claims regardless of the point of origin, even if such origin is within the jurisdictional boundaries of the Second, Fourth or Eighth Circuits, or any other circuit.

This Court's denial of the writ of certiorari requested by the Government would, obviously, allow the Court of Claims decision to stand, and thus become precedent nationwide for those taxpayers concerned with this issue. Since every such taxpayer, no matter where situated, could then either take their case to the Court of Claims and/or utilize *Vogel Fertilizer* as *stare decisis*, the denial of the request for a write of certiorari would have the effect of establishing and settling the law concerning the definition of a "brother-sister corporation" without the necessity for full review by this Court.[1] Cases currently pending or on appeal could be settled very simply in the same manner by citing the Court of Claims decision.

Hence, the Government's fears that the "conflict" would affect the uniform administration of the revenue laws, and thus require this Court to grant its request for a writ of certiorari, are unfounded. The situation is in reality quite the opposite — denial of the request for certiorari would have the effect of establishing a uniform rule through the national jurisdiction of the Court of Claims. It would then be the rightful responsibility of the legislature to rewrite I.R.C. § 1563(a)(2) if further clarification or change was deemed necessary.

3. The Petitioner has misconstrued the Court of Claims position with regard to the Treasury Regulation in question. The Court of Claims plainly was looking not only at whether Treas. Reg. § 1.1563-1(a)(3) was a reasonable interpretation of the statute, but also whether it was plainly inconsistent with the statute and the intent of Congress in enacting such statute.

---

[1] It is well understood by Respondent that in most instances, the denial of a writ of certiorari is not intended or designed to reflect this Court's views as to the merit of any particular case. However, in this instance it is urged that such a denial would serve a valid purpose.

The Court of Claims held that the Regulation was *both* "plainly inconsistent" with the statute *and* implemented the statute in an unreasonable manner. The Court of Claims stated: "In this case, therefore, the regulation either adds nothing not already in the statute or is inconsistent with the statute." Petitioner's Brief for Certiorari at 34a. The Court of Claims also stated: "In addition to concluding that Treas. Reg. § 1.1563-1(a)(3) is inconsistent with Congress' intent as evidenced by the legislative history, we have further determined that the regulation is an unreasonable interpretation of the statute." Petitioner's Brief for Certiorari at 28a. Hence, despite the arguments of the Government, the Regulation fails under the very test cited by the Government and based on *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496 (1948) and that case's progeny. See Petitioner's Brief for Certiorari at 12.

The Treasury simply should not be allowed to unilaterally expand the scope of I.R.C. § 1563 by regulation beyond that intended by Congress. As the Court of Claims clearly recognized, once Congress has established the scope and impact of a statutory provision, the Commissioner cannot expand the intended impact by adding to the statute what he thinks Congress has overlooked, even if for the purpose of improving the health of the fisc or for improving the phraseology of the statute. If it is shown, as it has herein, that a situation is not considered by Congress to be an "abuse," then the Commissioner by regulation is not entitled or empowered to arbitrarily label that situation an "abuse" situation and regulate against it. 1 *Mertens Law of Federal Income Taxation* § 3.21 (rev. 1974); *Arkansas-Oklahoma Gas Co. v. Commissioner*, 365 F.2d 760 (5th Cir. 1966); *United States v. Calamaro*, 354 U.S. 351 (1957). In other words, a regulation cannot take away what the Congress has given, as Treas. Reg. § 1.1563-1(a)(3) is attempting to do in this matter. *Mississippi*

River Fuel Corp. v. United States, 314 F.2d 953 (Ct. Cl. 1963).

CONCLUSION

It is respectfully argued that Petitioner has failed to sustain its burden of establishing special and important reasons why the writ should be granted. The Court of Claims correctly found that Treas. Reg. § 1.1563-1(a)(3) is invalid and unjustifiably expanded I.R.C. § 1563(a)(2). Therefore, it is submitted that the Petitioner's request for a writ of certiorari should be denied.

Respectfully submitted.

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UNITED STATES OF AMERICA, PETITIONER

v.

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ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Section 1561(a) of the Internal Revenue Code of 1954 (26 U.S.C.) provides that a "controlled group of corporations" shall be limited to a single corporate surtax exemption. Under Section 1563(a)(2), a "controlled group of corporations" includes a "brother-sister group," which is defined in part as "[t]wo or more corporations if 5 or fewer persons who are individuals * * * own * * * stock" possessing 80% of the total combined voting power of all classes of voting stock or of the total value of all classes of the stock of each corporation.

The question presented is whether the statutory definition is met if the "5 or fewer persons" own the prescribed 80% of the stock singly or in combination, as the governing Treasury Regulations provide, or whether each person whose stock is to be taken into account must own stock in each corporation of the group, as the decision below held.

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BRIEF FOR THE UNITED STATES

OPINION BELOW

The opinion of the Court of Claims (Pet. App. 1a-42a) is reported at 634 F.2d 497.

JURISDICTION

The opinion of the Court of Claims was filed on August 13, 1980. The order denying rehearing en banc was entered on October 3, 1980 (Pet. App. 43a). The judgment of the Court of Claims was entered on November 28, 1980 (Pet. App. 44a). The petition for a writ of certiorari was filed on January 23, 1981, and was granted on March 23, 1981. The jurisdiction of this Court rests on 28 U.S.C. 1255.

STATUTE AND REGULATIONS

The relevant provisions of Section 11(d), 1561(a) and 1563(a)(2) of the Internal Revenue Code of 1954 (26 U.S.C.), and of Treasury Regulations, Section 1.1563-1(a)(3) (26 C.F.R.), are set forth at Appendix, *infra*, 1a-4a.

STATEMENT

1. Respondent Vogel Fertilizer Company is an Iowa corporation in the business of selling farm fertilizer products at retail to local customers. During 1973-1975, respondent had only common stock issued and outstanding, which was owned by Arthur Vogel (113,575 shares—77.49%) and Richard Crain (33,000 shares—22.51%) (Pet. App. 2a).

Vogel Popcorn Company is a separate corporation engaged in a business unrelated to that of respondent. During 1973-1975, Vogel Popcorn had issued and outstanding 440,602 shares of common stock, all of which was owned by Arthur Vogel, and 62,866 shares of voting preferred stock, all of which was held by Arthur Vogel as trustee of the Alex Vogel Family Trust. As a result, Arthur Vogel owned 87.5% of all classes of Vogel Popcorn stock entitled to vote. The Alex Vogel Trust in turn owned 12.5% of such stock (Pet. App. 2a).

In its corporate income tax returns for the taxable years 1973-1975, respondent originally treated itself and Vogel Popcorn as members of a brother-sister controlled group of corporations as defined by Section 1563(a)(2). This position was in accord with the governing Treasury Regulation (Section 1.1563-1(a)(3)), which generally provides that the term "'brother-sister controlled group'" means "two or more corporations if the same five or fewer persons

* * * own * * * *singly or in combination*, stock possessing—(a) [a]t least 80 percent of the total combined voting power of all classes of stock * * * of each corporation; and (b) [m]ore than 50 percent of the total combined voting power of all classes of stock * * * of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation" (emphasis added) (Pet. App. 2a, 4a-5a).

Because respondent treated itself as a member of a controlled group of corporations, it did not claim the full corporate surtax exemption provided by Section 11(d) of the Internal Revenue Code of 1954. For its taxable years ended November 30, 1973 and 1974, respondent elected to utilize the multiple surtax exemption under Sections 1562 and 1564(a) and to pay the multiple surtax penalty imposed by Section 1562(b). For the taxable year ended November 30, 1975, respondent elected under Section 1561(a)(2) to allocate the single surtax exemption then allowed to members of a controlled group of corporations entirely to Vogel Popcorn (Pet. App. 3a).

Respondent thereafter filed timely claims for refund for each of the years in question. In those claims, respondent disavowed the position taken on its returns that it and Vogel Popcorn were members of a controlled group of corporations. Respondent now argued that it and Vogel Popcorn were not so related and that therefore it was entitled to a full surtax exemption for each taxable year. After the Internal Revenue Service disallowed respondent's claims on the authority of the governing Treasury Regulations, respondent commenced this refund suit in the United States Court of Claims (Pet. App. 3a).

2. A divided panel of the Court of Claims upheld respondent's position that it was entitled to a separate surtax exemption (Pet. App. 1a-36a). It first pointed out that the dispute between the parties involved only the 80% test of Section 1563(a)(2)(A). Specifically, the question presented was whether Richard Crain, who held no stock in Vogel Popcorn, could be counted as one of the group of "five or fewer persons" who held 80% of the stock of each corporation. In arguing that Richard Crain could not be so counted, respondent conceded that the Treasury Regulations (Section 1.1563-1(a)(3)(ii)) explicitly provided that "five or fewer persons" can own 80% of the stock of both corporations, singly or in combination, and included an example corresponding exactly to the facts of this case (Pet. App. 6a).

After acknowledging that three circuits had upheld the validity of the Regulation which was the basis of the government's position,[1] the Court of Claims struck down the Regulation and instead approved "the statutory construction made by the Tax Court in *Fairfax Auto Parts of Northern Virginia, Inc.* v. *Commissioner*, * * * 65 T.C. [798] at 802-803 [(1976, rev'd, 548 F.2d 501 (4th Cir.), cert. denied, 434 U.S. 904 (1977) as] the most careful and best analysis of the statute to date" (Pet. App. 8a; footnote omitted). In the Court of Claims' view, the statutory term "each such person" in the 50% test of Section 1563(a)(2)(B) modified the earlier phrase

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[1] *Fairfax Auto Parts of Northern Virginia, Inc.* v. *Commissioner*, 65 T.C. 798 (1976), rev'd, 548 F.2d 501 (4th Cir.), cert. denied, 434 U.S. 904 (1977); *Allen Oil Co.* v. *Commissioner*, 614 F.2d 336 (2d Cir. 1980); *T. L. Hunt, Inc.* v. *Commissioner*, 562 F.2d 532 (8th Cir. 1977).

in subsection (2)—"5 or fewer persons". As a result, the court concluded that for a person's stock ownership to be taken into account for purposes of the 80% test of Section 1563(a)(2)(A), that person must own stock in each member of the brother-sister controlled group (Pet. App. 10a).

In so holding, the Court of Claims "admitted that the different view taken by Treas. Reg. § 1.1563-1(a)(3) * * * [that the "5 or fewer persons" could own the prescribed percentages of stock singly or in combination] [is] not wholly unreasonable as a construction of the words appearing in section 1563(a)(2)" (Pet. App. 12a). However, the court ruled that the Regulation is "clearly inconsistent with the legislative history and unreasonable when the purpose, as well as the bare words, of the statute are considered" (Pet. App. 12a).

3. The dissenting judge would have upheld the validity of the Regulation (Pet. App. 36a-42a). As he saw the matter, "the issue is not whether [respondent's] interpretation is *as* reasonable as [the government's]; clearly that will be true in certain given factual situations. The issue is whether [respondent] has carried its heavy burden of showing the regulation to be unreasonable and plainly inconsistent with the statute. This [respondent] cannot do or at least has not done" (emphasis in original) (Pet. App. 38a).

The dissent noted that if Richard Crain owned but a single share of stock in Vogel Popcorn, then the two corporations would have constituted a brother-sister group even under the majority's interpretation (Pet. App. 41a). Absent any proof "that Congress intended the mechanical test which the ma-

jority had in mind and which leads to the unreasonable results just described" (Pet. App. 42a), the dissent would have disallowed respondent's claim on the authority of the Regulation.

SUMMARY OF ARGUMENT

1. In holding that respondent and Vogel Popcorn were not members of a "brother-sister" controlled group of corporations within the meaning of Section 1563(a) of the Internal Revenue Code of 1954 because the same persons were not shareholders in both corporations, the Court of Claims' decision is at odds with the plain language and structure of the statute, its legislative history, and the governing Treasury Regulations.

Section 1561(a) of the Code provides that a "controlled group of corporations" shall be limited to a single corporate surtax exemption. In enacting the statute, Congress sought to provide an objective mathematical test to eliminate income splitting among corporations operated as one economic entity. Under Section 1563(a)(2), a controlled group includes a "brother-sister group," which consists of "[t]wo or more corporations if 5 or fewer persons who are individuals * * * own * * * stock" possessing—

> (A) at least 80 percent of the * * * stock of each corporation, and
>
> (B) more than 50 percent of the * * * stock of each corporation, *taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.* [Emphasis added.]

Under the statute, subparagraphs (A) and (B) set forth an 80% test and a 50% test. The only substantive difference between the two tests is the italicized language of subparagraph (B), which introduces a limitation not applicable to the 80% test. Thus, the stock owned by any or all of the five persons may be taken into account in determining whether the 80% test has been met. On the other hand, in determining whether the 50% test has been satisfied, it is necessary to ascertain which of such persons owns stock in both of the corporations and how much each of them owns. Only to the extent that a person owns stock in each of the corporations is his stock taken into account for purposes of the 50% test. Accordingly, a person who owned no stock in one of the corporations would be excluded from consideration for purposes of that test. That is the import of the italicized language of subparagraph (B)—"taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation."

Applying the statute to the facts of the instant case, Arthur Vogel owned 77.49% of the voting stock of respondent Vogel Fertilizer and 87.5% of the voting stock of Vogel Popcorn. Richard Crain owned the remaining 22.51% of respondent Vogel Fertilizer's voting stock. Hence, using the figure 77.49% as the identical stock ownership of Arthur Vogel, it is clear that "5 or fewer persons" owned more than 50% of the voting stock of both corporations. Since it can hardly be disputed that "5 or fewer persons" owned at least 80% of the voting stock of both corporations —unless one adds unstated conditions to Section 1563

(a)(2)(A)—the Commissioner properly determined that respondent and Vogel Popcorn were entitled to only one surtax exemption, as originally reported on their returns.

The foregoing analysis is squarely supported by Treasury Regulations, Section 1.1563-1(a)(3) (26 C.F.R.) (App., *infra*, 3a-4a), which provides that "[t]he term 'brother-sister controlled group' means two or more corporations if the same five or fewer persons who are individuals * * * own * * * *singly or in combination*, stock possessing * * * [the requisite voting power]" (emphasis added). Indeed, the Regulations (Section 1.1563-1(a)(3)(ii)) set forth an example, which demonstrates that the 50% test may be satisfied even though each of the "5 or fewer persons" does not own stock in each corporation.

In ruling that the 80% test of subparagraph (A) is not satisfied unless each of the "5 or fewer persons" owns stock in each corporation, the Court of Claims relied, in part, upon the phrase "each such person" in subparagraph (B) and concluded that the phrase refers to the "5 or fewer persons" for purposes of both the 80% *and* 50% tests (Pet. App. 10a). Quoting with approval from the Tax Court's opinion in *Fairfax Auto Parts of Northern Virginia, Inc.* v. *Commissioner*, *supra*, 65 T.C. at 802-803, the court concluded that the statute "requires the same persons to be in the group of controlling stockholders used in both tests" (Pet. App. 10a-11a).

But the fundamental error of the Court of Claims (as well as of the Tax Court and the Fifth Circuit in *Delta Metalforming Co.* v. *Commissioner*, 632 F.2d 442 (1980), petition for cert. pending, No. 80-1499 (filed Mar. 4, 1981)) in interpreting Section

1563(a)(2) was to ignore the fact that the phrase "each such person" is found only in subparagraph (B) with respect to the 50% test. Thus, the natural reading of "each such person" is that it refers only to those persons owning more than 50% of the voting stock of each corporation, in subparagraph (B), rather than modifying the "5 or fewer persons" set forth in the prefatory part to paragraph (2).

There is consequently no justification, as a matter of grammar or logic, for singling out the phrase "each such person" in subparagraph (B) and transporting it for application in the context of subparagraph (A). Indeed, Congress would hardly have relied upon language at the end of subparagraph (B) in order to impose a requirement that the ownership group for purposes of subparagraph (A) include only those persons who own stock in each corporation.

2. The legislative history of Section 1563(a) confirms the correctness of our submission that under the plain language of Section 1563(a) the 80% test and the 50% test are independent parts of the statute. The 80% test antedated the 50% test. As originally enacted by the Revenue Act of 1964, Pub. L. No. 88-272, Section 235(a), 78 Stat. 120, Section 1563(a)(2) defined a brother-sister controlled group to be two or more corporations, if 80% of the total combined voting power or value of the shares was owned by one person. Because that rule failed to prevent the abuse of a group of corporations operated as a single economic entity claiming multiple surtax exemptions, Congress expanded the definition of a controlled group in the Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(c), 83 Stat. 602. To make the rule applicable in more situations, the stock ownership of up to five persons was to be taken

into account. However, Congress added the 50% test to assure that there would be common control of each of the corporations by some of the group.

Accordingly, the most telling point against the statutory interpretation by the decision below is that under the Court of Claims' view, respondent and Vogel Popcorn would have constituted a brother-sister controlled group if Richard Crain owned but a single share of Vogel Popcorn. Here, it is clear that Arthur Vogel—owning 77.49% of respondent's voting stock and 87.5% of Vogel Popcorn's voting stock—had the power to operate both corporations as a single economic entity. But under the majority's view, the corporations were not brother-sister and were therefore entitled to two surtax exemptions, a result that would be changed if Richard Crain owned a single share of Vogel Popcorn. Surely, Richard Crain's ownership of a single share in Vogel Popcorn would have added nothing of any economic significance. Hence, the court's gloss upon Section 1563(a) would impede the legislative purpose of denying multiple surtax exemptions to those corporations which are operated as a single economic entity. Indeed, it is difficult to imagine that Congress intended the statute to turn upon such minute distinctions which make no economic difference.

3. While we believe that the language of Section 1563(a)(2) and its legislative history support the conclusion that the 50% test is satisfied if "5 or fewer persons" own stock in each corporation either singly or in combination, the question in this case is not whether the Court of Claims has reached a more reasonable interpretation of the statute. Given the existence of a controlling Treasury Regulation and an example specifically addressed to the facts of

this case, the question is whether the Regulation is a reasonable interpretation of the statute. This Court has repeatedly ruled that as " 'contemporaneous constructions by those charged with administration of' the Code, [Treasury] Regulations" must be upheld if they are not plainly inconsistent with the statute and if they implement the statute in a reasonable way. *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948); *Bingler* v. *Johnson*, 394 U.S. 741, 749-750 (1969); *Fulman* v. *United States*, 434 U.S. 528, 533 (1978); *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472 (1979); *Commissioner* v. *Portland Cement Co.*, No. 79-1907 (Mar. 3, 1981), slip op. 12.

Here, it cannot be disputed that the controlling Treasury Regulation interprets the statutory language in a reasonable manner. Indeed, apart from the three circuits that have upheld the Regulation,[2] even the Court of Claims "admitted that the different view taken by Treas. Reg. § 1.1563-1(a)(3) is not wholly unreasonable as a construction of the words appearing in section 1563(a)(2)" (Pet. App. 12a). See also *Delta Metalforming Co.* v. *Commissioner*, *supra*, 632 F.2d at 446. And, as we have shown, that construction is consistent with the legislative history and purpose of the pertinent statutory provisions. It was, therefore, not open to the court to adopt an interpretation at variance with the Regulation even though it believed that its reading of the statute was equally or even more reasonable. In short, a court cannot set

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[2] *Fairfax Auto Parts of Northern Virginia, Inc.* v. *Commissioner*, 548 F.2d 501 (4th Cir.), cert. denied, 434 U.S. 904 (1977); *Allen Oil Co.* v. *Commissioner*, 614 F.2d 336 (2d Cir. 1980); *T. L. Hunt, Inc.* v. *Commissioner*, 562 F.2d 532 (8th Cir. 1977).

aside a reasonable Treasury Regulation in favor of another interpretation that it deems preferable. In this respect, this Court's admonition in *United States* v. *Correll*, 389 U.S. 299 (1967), is particularly appropriate. In upholding the Commissioners' overnight rule concerning the deductibility of meals consumed during business travel, the Court there stated, in terms that are equally applicable to this case (*id.* at 306-307):

> Alternatives * * * are of course available. Improvements might be imagined. But we do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. * * * The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner.

ARGUMENT

TWO OR MORE CORPORATIONS CONSTITUTE A BROTHER-SISTER CONTROLLED GROUP UNDER SECTION 1563(a)(2)(A) OF THE INTERNAL REVENUE CODE IF FIVE OR FEWER INDIVIDUALS OWN 80 PERCENT OF THEIR STOCK SINGLY OR IN COMBINATION

A. The Governing Treasury Regulations Explicitly Provide that the Term "Brother-Sister Controlled Group" means Two Or More Corporations if the Same Five or Fewer Individuals Own the Prescribed Percentage of Stock Singly Or In Combination

Each corporation subject to the income tax is entitled to a relatively low normal rate on a prescribed initial amount of its taxable income. Beyond that amount, its

taxable income is subject to surtax rates. As a result, taxpayers have sought to increase the amount of income eligible for the lower normal rate by splitting the income of a common business enterprise among several corporations.[3] Prior to 1964, the Treasury attacked such arrangements under Sections 269, 482, and 1551 of the Internal Revenue Code of 1954. However, when the Commissioner disallowed claims to multiple surtax exemptions under those provisions, the taxpayers could show their entitlement by establishing that the securing of an additional surtax exemption was not a major purpose of the use of more than one corporation. In the Revenue Act of 1964, Pub. L. No. 88-272, Section 235(a), 78 Stat. 120, Congress sought to eliminate the need for such factual determinations by adding Sections 1561-1563 to the Code. For the first time, these provisions empowered the Commissioner to disallow a corporate surtax exemption even though the taxpayer might be able to show a non-tax reason for employing a multiple corporate structure. As we shall show, these provisions were further refined by the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, in a manner that gives rise to the controversy in this case.

Accordingly, Sections 1561-1563 provide an objective mathematical control test for determining

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[3] For the taxable years in issue (1973-1975), Section 11(b) of the Code imposed a normal tax of 20% of the first $25,000 of taxable income and 22% of the amount exceeding $25,000. Section 11(c) imposed a surtax of 26% of the amount by which the taxable income of a corporation exceeded the surtax exemption as provided for in Section 11(d). For the first two taxable years here in issue (the years ending November 30, 1973 and 1974), the exemption was $25,000 and, for the third year (ending November 30, 1975), was $50,000. The larger exemption for the last year is the result of a 1975 statutory amendment (Section 303(b), Act of Mar. 29, 1975, Pub. L. No. 94-12, 89 Stat. 44).

under what circumstances a group of corporations is entitled to only a single surtax exemption. Section 1561 of the Code (App., *infra*, 1a) provides that the members of a "controlled group of corporations" shall be limited to a single surtax exemption under Section 11(d). Section 1563(a)(2) (App., *infra*, 2a-3a) defines the term "controlled group of corporations" as follows:

> (a) CONTROLLED GROUP OF CORPORATIONS—For purposes of this part, the term "controlled group of corporations" means any group of—
>
> * * * * *
>
> (2) BROTHER-SISTER CONTROLLED GROUP—Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing—
>
> (A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and
>
> (B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, *taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.* [Emphasis added.]

Under the statute, subparagraphs (A) and (B) set forth an 80% test and a 50% test. The only substantive difference between the two tests (other than the prescribed percentage) is the italicized language of subparagraph (B), which introduces a limitation not applicable to the 80% test. Thus,

the stock owned by any or all of the five persons may be taken into account in determining whether the 80% test has been met. This aspect of the statute insures that the corporations covered by the statute will be of closely-held character. On the other hand, in determining whether the 50% test has been satisfied, it is necessary to ascertain which of such persons owns stock in each of the corporations and how much each of them owns. Only to the extent that a person owns stock in each of the corporations is his stock taken into account for purposes of the 50% test. Accordingly, a person who owned no stock in one of the corporations would be excluded from consideration for purposes of that test. That is the import of the italicized language of subparagraph (B)—"taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation." This aspect of the statute insures commonality, *i.e.*, that the same interests will control all members of the group.

Applying the statute to the facts of the present case, Arthur Vogel owned 77.49% of the voting stock of respondent Vogel Fertilizer and 87.5% of the voting stock of Vogel Popcorn. Richard Crain owned the remaining 22.51% of respondent Vogel Fertilizer's voting stock. Hence, using the figure 77.49% as the identical stock ownership of Arthur Vogel, it is clear that "5 or fewer persons" owned more than 50% of the voting stock of both corporations within the meaning of subparagraph (B).

This much is undisputed. However, the question presented, on which the lower courts have divided, is whether "5 or fewer persons" own 80% of the stock of each corporation within the meaning of subparagraph (A) where each of them does not own stock

in each corporation. As a matter of simple textual examination of the statute, it would appear that the 80% test would be met in such circumstances. Here, two persons—Arthur Vogel (77.49%) and Richard Crain (22.51%)—owned 100% of the stock of respondent Vogel Fertilizer. Moreover, one of those persons—Arthur Vogel—owned 87.5% of the stock of Vogel Popcorn. Hence, unless one adds unstated conditions to the 80% test of Section 1563(a)(2)(A), the literal terms of the statute support the Commissioner's determination that respondent and Vogel Popcorn were entitled to only one surtax exemption, as originally reported on their returns.

2. But we do not rest our case for disallowance of respondent's multiple surtax exemptions here on a statutory construction of our own making. As we shall show in greater detail (pages 16-19, *infra*), the Commissioner's case for disallowance is squarely supported by Treasury Regulations (Section 1.1563-1(a)(3) (26 C.F.R.) (App., *infra*, 3a-4a)) that provide that "[t]he term 'brother-sister controlled group' means two or more corporations if the same five or fewer persons who are individuals * * * own * * * *singly or in combination*, stock possessing * * * [the requisite voting power]" (emphasis added). Moreover, the Regulations (Section 1.1563-1(a)(3)(ii)) set forth the following example, which specifically addresses the facts of this case and demonstrates that the 80% test may be satisfied even though each of the "5 or fewer persons" does not own stock in each corporation. The pertinent example states as follows:

"Example (1). The outstanding stock of corporations P, Q, R, S, and T, which have only one class of stock outstanding, is owned by the following unrelated individuals:

Individuals	Corporations					Identical Ownership
	P	Q	R	S	T	
A	60%	60%	60%	60%	100%	60%
B	40%	—	—	—	—	—
C	—	40%	—			
D	—	—	40%			
E	—	—	—	40%	—	
Total	100%	100%	100%	100%	100%	60%

Corporations P, Q, R, S, and T are members of a brother-sister controlled group."

If, as we submit, the Regulation is a reasonable interpretation of the statute, that is the end of the matter and the decision below ruling it invalid should be reversed. Three circuits have so upheld the validity of the Commissioner's Regulations. *Fairfax Auto Parts of Northern Virginia, Inc.* v. *Commissioner*, 548 F.2d 501 (4th Cir.), cert. denied, 434 U.S. 904 (1977); *Allen Oil Co.* v. *Commissioner*, 614 F.2d 336 (2d Cir. 1980); *T. L. Hunt, Inc.* v. *Commissioner*, 562 F.2d 532 (8th Cir. 1977). See also *Yaffe Iron & Metal Corp.* v. *United States*, 593 F.2d 832 (8th Cir. 1979). Contra: *Commissioner* v. *Delta Metalforming Co.*, 632 F.2d 442 (5th Cir. 1980), petition for cert. pending, No. 80-1499, (filed Mar. 4, 1981). Indeed, even though it held to the contrary, the Court of Claims (Pet. App. 12a) "admitted that the different view taken by Treas. Reg. § 1.1563-1(a)(3) is not wholly unreasonable as a construction of the words appearing in section 1563(a)(2)." Thus, the

question before the Court necessarily turns on the Secretary's authority to issue such Regulations interpreting the term "brother-sister controlled group" of corporations.

The existence of controlling Treasury Regulations with an example explicitly including the facts of this case within the scope of the statutory definition of "brother-sister controlled group" imposes a heavy burden on respondent who seeks to challenge the Commissioner's disallowance of its separate corporate surtax exemption on the authority of those Regulations. It must show that the Regulations are unreasonable and plainly inconsistent with the statute. In our view, it has done neither. It is fundamental that as "contemporaneous constructions by those charged with administration of" the Code, the Regulations "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes" and "should not be overruled except for weighty reasons" *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948). Accordingly, "[t]he role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner." *United States* v. *Correll*, 389 U.S. 299, 307 (1967). As a unanimous Court reaffirmed only this Term in *Commissioner* v. *Portland Cement Co.*, No. 79-1907 (Mar. 3, 1981), slip op. 12, with respect to the substantial weight to be given such Regulations—

> These regulations command our respect, for Congress has delegated to the Secretary of the Treasury, not to this Court, the task "of ad-

> ministering the tax laws of the Nation." *United States* v. *Cartwright*, 411 U.S. 546, 550 (1973); accord, *United States* v. *Correll*, 389 U.S. 299, 307 (1967); see 26 U.S.C. § 7805(a). We therefore must defer to Treasury Regulations that "implement the congressional mandate in some reasonable manner." *United States* v. *Correll*, 389 U.S., at 307; accord, *National Muffler Dealers Assn.* v. *United States*, 440 U.S. 472, 476-477 (1979). To put the same principle conversely, Treasury Regulations "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes." *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948); accord, *Fulman* v. *United States*, 434 U.S. 528, 533 (1978); *Bingler* v. *Johnson*, 394 U.S. 741, 749-751 (1969).

See also *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 533 n.11 (1979).

We turn now to a discussion of the language and history of the statute which we believe demonstrate that the Commissioner's Regulation here falls well within his authority to interpret the statute in a reasonable manner consistent with the congressional mandate.

B. The Treasury Regulations are Consistent With the Language and Structure of Section 1563(a)(2)

1. "It is elementary that '[t]he starting point in every case involving construction of a statute is the language itself'" *Southeastern Community College* v. *Davis*, 442 U.S. 397, 405 (1979). See also *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 568 (1979). The critical words of Section 1563(a)(2)

define a "controlled group of corporations." A "brother-sister controlled group" is one of—

> (2) * * * Two or more corporations if 5 or fewer persons * * * own * * *
>
> (A) at least 80 percent of the * * * stock of each corporation, and
>
> (B) more than 50 percent of the * * * stock of each corporation, *taking into account the stock ownership of each such person only to the extent that such stock ownership is identical with respect to each such corporation.* [Emphasis added.]

The most striking characteristic of the statutory language and structure is that the conditions insuring common control in the 50% test of subparagraph (B)—the italicized portion—are exclusive to that subparagraph. They do not appear at all in the 80% test of subparagraph (A). Hence, a natural reading of the statute yields two conclusions. First, the 80% test is met if five or fewer persons own at least 80% of the stock of each corporation. Second, it is only with respect to the 50% test that the statute imposes the requirement that some of the five or fewer persons own stock in each corporation.

As we have pointed out (*supra*, page 15), it is undisputed that the overlapping control requirement of the 50% test of subparagraph (B) is met in this case because Arthur Vogel owned 77.49% of the voting stock of respondent Vogel Popcorn. Using 77.49% as the identical percentage figure, it is plain that a group of five or fewer persons (*viz.*, Arthur Vogel and Richard Crain) owned more than 50% of the stock of each corporation.

It is likewise plain that the literal terms of subparagraph (A) have been met. Arthur Vogel and Richard Crain respectively owned 77.49% and 22.51% of the stock of Vogel Fertilizer, and Arthur Vogel owned 87.5% of the stock of Vogel Popcorn. Hence, "5 or fewer persons * * * own * * * at least 80 percent of the * * * stock of each corporation" within the meaning of Section 1563(a)(2)(A).

Despite the force of the plain language of the statute, the decision below resisted the conclusion that the facts of this case meet the literal terms of Section 1563(a)(2)(A). In holding that the 80% test of subparagraph (A) is not satisfied unless each of the "5 or fewer persons" owns stock in each corporation, the Court of Claims pointed to the phrase "each such person" in subparagraph (B) and concluded that the phrase refers to the same "5 or fewer persons" for purposes of both the 80% *and* 50% tests (Pet. App. 10a). Quoting with approval from the Tax Court's opinion in *Fairfax Auto Parts of Northern Virginia, Inc.* v. *Commissioner*, 65 T.C. 798, 802-803 (1976), rev'd, 548 F.2d 501 (4th Cir.), cert. denied, 434 U.S. 904 (1977), the court concluded that the statute requires the same persons to be stockholders in both corporations.

But nothing in the language of the statute requires that the same persons own stock in both corporations. Contrary to the decision below, the phrase "each such person" does not compel, much less imply, such a conclusion. The fundamental error of the Court of Claims (as well as the Tax Court) in interpreting Section 1563(a)(2) was to ignore the fact that the phrase "each such person" is found only in subpara-

graph (B) with respect to the 50% test. Accordingly, the natural reading of "each such person" is that it refers only to those persons owning more than 50% of the voting stock of each corporation, only for purposes of subparagraph (B), and does not modify the phrase "5 or fewer persons," as that term comes into play in the application of the 80% test of subparagraph (A). As the Eighth Circuit concluded in *T.L. Hunt, Inc.* v. *Commissioner*, 562 F.2d 532, 535 (8th Cir. 1977), "[t]hus, it is apparent that Congress was aware of the language necessary to require that each person whose holdings are considered in applying the 80% test must own stock in each of the controlled corporations. We find nothing in the plain words of the statute which warrants applying such standard with respect to the § 1563(a)(2)(A) test."

There is consequently no justification, as a matter of grammar or logic, for singling out the phrase "each such person" in subparagraph (B) and transporting it for application in the context of subparagraph (A). "Such interpretation of the statute overlooks the obvious fact that those words are contained in subparagraph (B); they restrict the applicability of the 50-percent test but have absolutely nothing to do with the 80-percent test." *Fairfax Auto Parts of Northern Virginia, Inc.* v. *Commissioner, supra*, 65 T.C. at 812 (Simpson, J., dissenting, joined by Raum, Tannenwald, and Wilbur, JJ.).

Indeed, if the Court of Claims' partially amalgamated reading of subparagraphs (A) and (B) were correct, one could conclude with equal justification (contrary to even the decision below) that the entire italicized portion of subparagraph (B)—not just the

phrase "each such person"—modifies the phrase "5 or fewer persons" for purposes of applying subparagraph (A). Under such a reading of the statute, the 80% test would necessarily swallow up and displace the 50% test. The Second Circuit in *Allen Oil Co.* v. *Commissioner*, 614 F.2d 336, 339 (1980), correctly "reject[ed] the taxpayer's argument as a highly strained and convoluted reading of the statute." As the court there further observed, "[m]oreover, [that argument] proves too much. To read such a requirement into the 80% test would seriously weaken subparagraph (2)(B) and its 50% test since the 80% requirement if subjected to common ownership on the part of the group of five or fewer, would then tend to overlap or swallow the 50% identical ownership requirement."

In advancing the foregoing analysis, we do not suggest that the Court of Claims intended to transport the entire italicized portion of subparagraph (B) into subparagraph (A) and thereby obliterate the 50% test of subparagraph (B). Rather, our purpose is simply to point out that once one assumes (as did the decision below) that part of subparagraph (B) is germane for interpreting subparagraph (A), there is no convincing analysis that demonstrates which portions (if any) of subparagraph (B) are properly imported into subparagraph (A). Put another way, the statutory interpretation by the Court of Claims contains no limiting principle that makes any particular portion of subparagraph (B) any more or less appropriate for importation into subparagraph (A). In the absence of any such limiting principle, the 80% and 50% tests should therefore be regarded as separate components of the statute that are to be independently applied.

In sum, there is no justification for importing any part of subparagraph (B) into subparagraph (A), let alone the phrase "each such person", as the decision below construed the statute. As a result, there is no requirement that can be derived from the language of the statute that the same persons constitute the shareholder group for purposes of both the 80% and 50% tests. Indeed, Congress would hardly have relied upon language at the end of subparagraph (B) in order to impose a requirement that the same shareholders constitute the ownership group for purposes of subparagraph (A). If Congress sought to accomplish that result, common sense dictates that such a requirement would have been incorporated directly into the text of subparagraph (A). In this respect, the Second Circuit similarly recognized that "[a]bsent some illumination from the legislative history, we must conclude that if Congress had intended to limit the 80% test to situations where each stockholder owns shares in each member of the corporate group, it would have explicitly provided for it. Instead, it expressly required that only identically owned stock be counted for the 50% test and imposed no common ownership condition upon computation of stock ownership for the 80% test." *Allen Oil Co.* v. *Commissioner*, *supra*, 614 F.2d at 339. Accord: *T.L. Hunt, Inc.* v. *Commissioner*, *supra*, 562 F.2d at 535.

Finally, perhaps the most telling point against the statutory interpretation by the decision below is that under the Court of Claims' view, respondent and Vogel Popcorn would have constituted a brother-sister controlled group if Richard Crain owned but a single share of Vogel Popcorn. Here, it is clear that Arthur Vogel—owning 77.49% of respondent's voting stock and 87.5% of Vogel Popcorn's voting

stock—had the power to operate both corporations as a single economic entity. As we shall show (*infra*, pages 27-33), the legislative history indicates that Congress intended to disallow multiple surtax exemptions where corporations were controlled as a single economic entity. In concluding that the 80% test is not met unless each of the persons considered own some stock in each corporation, the Court of Claims has superimposed a gloss upon the statute that bears no relationship to the congressional purpose of reaching those corporations which are operated as a single economic entity.

From the standpoint of economic control, nothing of import would change in this case if Richard Crain owned a single share of Vogel Popcorn. In either instance, Arthur Vogel—with his 77.49% and 87.5% of respondent's and Vogel Popcorn's voting stock—would be no more or less able to control both corporations as a single economic entity. Although Crain's minimal ownership in Vogel Popcorn would have had no economic significance, the Court of Claims would have regarded Richard Crain's ownership of a single share of Vogel Popcorn as sufficient to disallow the multiple surtax exemptions. It is difficult to imagine that Congress intended the statute to turn upon such minute distinctions which make no economic difference.[4]

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[4] Although the Court of Claims acknowledged that Section 1563(a)(2) would apply under its interpretation if Richard Crain owned as little as one share in Vogel Popcorn, it nevertheless rejected the government's argument that Congress could not have intended to have the statute turn upon the happenstance of the ownership of a single share. As the court stated, "[i]t might well be appropriate not to consider the ownership of a token amount of stock if taxes could be

avoided by such ownership. Here the ownership of a token amount of stock would *increase* taxes, and Richard Crain would be most ill advised to acquire one share of stock in Vogel Popcorn and so cause the 80-percent test to be satisfied" (Pet. App. 33a; emphasis in original).

But the court's observation misses the critical point that its interpretation makes the statute turn on considerations that have no bearing on Congress' intent to disallow multiple surtax exemptions by corporate groups controlled as a single economic entity. The ownership by Richard Crain of one share of Vogel Popcorn would have vested him with a .00019% interest in the corporation—an amount that would neither have enhanced nor detracted from Arthur Vogel's essential economic control. Hence, the fact that Crain's ownership of a single share would have triggered, rather than foreclosed, application of the statute does not justify its interpretation that turns the application of the statute on such minute distinctions which make no economic difference. Moreover, the court's suggestion that it might have reached an alternative result if the ownership of a token share could have avoided taxes is equally ill-founded. If the shareholder group in subparagraph (A) owned one share less than 80% of the stock of one of the corporations, that would unquestionably foreclose application of the statute (see Pet. App. 28a n.14).

The Fifth Circuit's response to the single share point is similarly unconvincing. In *Delta Metalforming Co.* v. *Commissioner*, *supra*, 632 F.2d at 450, the court stated that it refused "to rewrite the numerical requirements of the statute." But our argument with respect to Crain's ownership of a single share of Vogel Popcorn does not undermine the 80% line of demarcation established by Congress. The Fifth Circuit's observation assumes the very conclusion in these cases, *viz.*, that the 80% test of subparagraph (A) requires common ownership of 80% of the stock by the same shareholders whose stock actually contributes to meeting the 50% test. In our view, the 80% test contains no such requirement. All that is necessary is that five or fewer persons own at least 80% of the stock of both corporations. Here, that requirement is met by Arthur Vogel (77.49%) and Richard Crain (22.51%).

C. The Legislative History of Section 1563 Supports the Governing Treasury Regulations

1. The legislative history of Section 1563 confirms the correctness of our submission that the statutory definition of "brother-sister group" is met if "5 or fewer persons" own the prescribed stock singly or in combination, as the governing Treasury Regulations provide.

Section 1563(a)(2) was originally enacted by the Revenue Act of 1964, Pub. L. No. 88-272, Section 235(a), 78 Stat. 116. It defined a brother-sister controlled group to be two or more corporations, if 80% of the total combined voting power, or 80% of the total combined value of the shares were owned by one person. However, the Treasury and Congress found the rule largely ineffectual because of the requirement that one person own 80% of the stock of each corporation before the group of corporations would be subject to disallowance of the multiple surtax exemptions or the imposition of a penalty. In order to make the rule applicable in a greater number of cases, the Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(c), 83 Stat. 602 expanded the number of shareholders under the 80% test from one to five, and added the 50% test to assure that there would still be common control of both of the corporations.

The general explanation of the Treasury Tax Reform Proposals contained in *Tax Reform, 1969: Hearings Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess., pt. 14, 5394-5395 (1969) (hereinafter cited as "*House Hearings*"), sets forth the following reasons for the new provisions:

> *Brother-sister groups.*—A group of corporations in which five or fewer persons own, to a large extent in identical proportions, at least 80

percent of the stock of each of the corporations. This provision expands present law by considering the combined stock ownership of five individuals, rather than one individual, in applying the 80-percent test. Even the mild 6-percent penalty under existing law for brother-sister corporations claiming multiple surtax exemptions is largely ineffectual because of the percent requirement that one person own 80 percent of the stock of each corporation before the group of corporations is subject to the penalty.

However, in order to insure that this expanded definition of brother-sister controlled group applies only to those cases where the five or fewer individuals hold their 80 percent in a way which allows them to operate the corporations as one economic entity, the proposal would add an additional rule that the ownership of the five or fewer individuals must constitute more than 50 percent of the stock of each corporation considering, in this test of ownership, stock of a particular person only to the extent that it is owned identically with respect to each corporation.

Thus, even where the 80 percent ownership test is met, the brother-sister definition will not apply unless the stockholdings of the individuals in the various corporations also meet the 50-percent identical ownership test (footnote omitted).

The foregoing explanation with respect to brother-sister groups supports the interpretation adopted by the governing Treasury Regulations that the "5 or fewer persons" constituting the shareholder group for purposes of the 50% test need not own stock in each corporation for purposes of the 80% test. Indeed, the first sentence of the Treasury explanation speaks of

"[a] group of corporations in which five or fewer persons own, *to a large extent in identical proportions*, at least 80 % of the stock of each of the corporations" (*House Hearings, supra*, at 5394; emphasis added; footnote omitted). The phrase "to a large extent" suggests that there need not be common ownership among all those persons taken into account for purposes of the 80% test; rather, that whatever common ownership is required is specified by the 50% test.

Moreover, the entire second paragraph confirms the correctness of this interpretation. It makes clear that different persons may be taken into consideration in applying the 80% and the 50% tests and that the common ownership requirement applies only to the 50% test. Hence, the explanation contrasts the "five or fewer individuals [who] hold their 80 percent" with the further requirement that "the ownership of the five or fewer individuals must constitute more than 50 percent of the stock of each corporation considering, in this test of ownership, *stock of a particular person* only to the extent that it is *owned identically with respect to each corporation*" (*House Hearings, supra*, at 5394; emphasis added). The juxtaposition of the phrase referring to the stock of "a particular person" (for purposes of the 50% test) to the "five or fewer individuals" (as to which the 80% test is applied) shows that different persons may be taken into account in applying the 80% and the 50% tests, and that the common ownership requirement applies only to the 50% test.[5]

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[5] Contrary to the Court of Claims' suggestion (Pet. App. 23a), the use of the word "insure" in the second paragraph of the Treasury document quoted above ("However, in order to insure that this expanded definition of brother-sister controlled group applies only to those cases * * *") does not

Both the Court of Claims in the instant case and the Fifth Circuit in *Delta Metalforming Co.* v. *Commissioner, supra,* also addressed the Treasury's General and Technical Explanation but concluded that it undermined the Regulation because of references in another portion of the Treasury document to "the same five or fewer persons" owning at least 80% of "each corporation" and "these five or fewer individuals" owning at least 50% of the stock of each corporation (see Pet. App. 21a; 632 F.2d at 447-448).[6] But

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support the conclusion that "[t]he 80-percent test therefore must measure substantial overlapping financial interests" (Pet. App. 23a), but, indeed, supports the contrary conclusion. As the court acknowledged (*ibid.*), "[t]he 50-percent test was added to 'insure,' not to establish, the unity of economic enterprise by measuring whether overlapping control exists." Since the 80% test, standing alone, would be incapable of "insuring" overlapping control (see Pet. App. 8a n.3), the word "insure" necessarily relates only to the 50% test and not, as the court below erroneously believed, the 80% test.

[6] The portion of the Treasury's Technical Explanation upon which the decision below relied provides as follows (*House Hearings, supra,* at 5168-5169; emphasis added):

> *Brother-sister controlled group.* Present law defines a brother-sister controlled group as a group of corporations in which the voting stock or value of shares of each member is owned 80 percent by the same person (*i.e.*, individual, estate or trust). *Under the proposal, the present definition would be changed so that a group of corporations would constitute a brother-sister controlled group if (1) the same five or fewer persons own at least 80 percent of the voting stock or value of shares of each corporation,* and (2) *these* five or fewer individuals own more than 50 percent of the voting power or value of shares of *each* corporation considering a particular person's stock only to the extent that it is owned identically

these references simply underscore the fact that the same group of five or fewer persons, rather than a different group, is to be considered in applying both the 80% and 50% tests. Contrary to the decision below, these references in the Treasury's Technical Explanation do not establish that each person whose stock is considered for purposes of the two tests must own stock in each corporation of the group.

2. Moreover, when Congress decided in 1969 to expand the coverage of Section 1563, it used exactly the same words as Section 1551(b)(2) to describe a brother-sister controlled group of corporations.

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with respect to each corporation. This definition is the same as that under section 1551 (relating to the disallowance of surtax exemptions and accumulated earning credits in cases of transfers in order to secure the exemption or credit).

Part (1) of this test is satisfied if the group of five or fewer persons as a whole owns at least 80 percent of the voting stock or a value of shares of each corporation, regardless of the size of the individual holdings of each person. Thus, for example, part (1) (but not necessarily part (2)) is met whether one person owns 80 percent of the voting stock of each corporation, four persons each own 20 percent of the voting stock of each corporation, or one person owns 60 percent of the voting stock of one corporation and 40 percent of another, and another person owns 40 percent of the voting stock of the first and 60 percent of the second.

Part (2) of the test is satisfied only if the same five or fewer persons own more than 50 percent of the voting stock or value of shares of each corporation, considering stock owned by a particular person only to the extent that it is owned identically in each of the corporations. Thus, for example, a person who owns 80 percent of the voting stock of one corporation and 30 percent of another would be considered as owning 30 percent of both corporations for purposes of part (2) of the test.

Thus, in expanding the 80% test to include as many as five shareholders and adding the overlapping control criteria of the 50% test, the pertinent House Committee on Ways and Means Report stated that "[t]he stock ownership test [for brother-sister controlled groups] would be the same test employed in Section 1551(b)(2) * * *." H.R. Rep. No. 91-413, (Pt. 2), 91st Cong., 1st Sess. 76 (1969). The Committee's statement is in accord with the Treasury's Technical Explanation that "[t]his definition is the same as that under Section 1551" (*House Hearings, supra*, at 5168). At that time, Treasury Regulations, Section 1.1551-1(g)(4) included an example (Example 4) indicating that the ownership of a person could be taken into account for purposes of the 80% test although he did not own stock in each of the corporations and was therefore not considered for purposes of the 50% test. Since the Treasury officials who drafted the 1969 amendments to Section 1563 were doubtless familiar with the Regulations under Section 1551, it is not unreasonable to assume that Congress intended that the same definitional terms in the two statutes should have the same meaning.

Although the Court of Claims (Pet. App. 25a-27a) and the Fifth Circuit in *Delta Metalforming Co.* v. *Commissioner, supra*, 632 F.2d at 450-451, acknowledged the similarity between Section 1563(a)(2) and 1551, they both rejected the inference that Congress intended to adopt the interpretation of the Section 1551 Regulations. In the Court of Claims' view, the examples under Section 1.1551-1(g)(4), of the Regulations "may indicate a contrary proposition" and "are intended as illustrations of the nature of the transfer required under that paragraph rather than as illus-

trations of the meaning and application of the term 'control' * * *" (Pet. App. 27a). But the plain fact is that Example (4) under Section 1.1551-1(g)(4) of the Regulation does show that under the identical statutory language, ownership of stock in both corporations is not a requirement under the 80% test. That the example may also demonstrate another proposition does not undermine the force of our argument that Congress intended Section 1551 and 1563 to be interpreted identically.

Contrary to the Fifth Circuit's observation in *Delta Metalforming Co.* v. *Commissioner*, *supra*, 632 F.2d at 450-451, the facts that Section 1551 requires a transfer and that the Section 1551 Regulations do not use the precise language of the Section 1563 Regulations—"singly or in combination"—does not render Section 1551 irrelevant. Given the identical language of the two statutes and the undisputed fact that an inference can be drawn from the Section 1551 Regulations that supports the validity of the Section 1563 Regulations, "it is immaterial that section 1551 applies when there is a transfer of property and that section 1563 applies without a showing of a transfer of property" *Fairfax Auto Parts of Northern Virginia, Inc.* v. *Commissioner*, *supra*, 65 T.C. at 810 (Simpson, J., dissenting).[7]

[7] A similar inference can be drawn from Section 1015 of the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 925, which added Section 414 to the Internal Revenue Code. Subsections (b) and (c) of that provision incorporate the control test of Section 1563(a). Since the Regulations under Section 1563 at issue were issued three years prior to the enactment of ERISA and no court had held them invalid at that time, it is reasonable to assume that Congress approved the Commissioner's construction that the same shareholders were not

3. a. Despite the support for the governing Treasury Regulations in the above-described legislative history, the decision below and the Fifth Circuit in *Delta Metalforming Co.* v. *Commissioner, supra,* concluded that the 1969 amendment to Section 1563(a) sought to apply the principle of common ownership to the 80% test as well as the 50% test. As those decisions view the matter, the 80% financial interest tests would be rendered meaningless unless the same group of five or fewer shareholders own 80% of each corporation. (See Pet. App. 22a; *Delta Metalforming Co.* v. *Commis-*

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required to own stock in each corporation for purposes of the 80% test. See *Helvering* v. *Winmill,* 305 U.S. 79, 83 (1938); *United States* v. *Correll, supra,* 389 U.S. at 305-306.

Moreover, while the failure of Congress to enact legislation is not dispositive, it is nevertheless significant that in 1974, the American Bar Association's Tax Section proposed an amendment to Section 1563(a) which would have vitiated the Treasury Regulations at issue in this case by incorporating the ownership requirements proposed by respondent and the decision below and the Fifth Circuit. Under the proposed amendment (Tax Section Recommendation No. 1974-1 (A.B.A.), 27 Tax Lawyer 813, 817 (1974)) Section 1563 (a)(2) would have read:

> (2) *Brother-sister controlled group.* Two or more corporations if *each of the same* 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock *in each corporation, such stock in the aggregate* possessing—
>
> > (A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each *such* corporation * * *. [Emphasis in original.]

Congress, however, has not adopted this, or indeed, any other change in the statute.

sioner, *supra*, 632 F.2d at 450; *T.L. Hunt, Inc.* v. *Commissioner*, *supra*, 562 F.2d at 537 (Webster, J., dissenting)).

We submit that the 80% test continues to have independent significance under the statutory interpretation of the Treasury Regulations. It insures that all the members of the corporate group will be closely held thereby facilitating their operation as a single economic enterprise. To be sure, part of this goal is achieved by the overlapping control requirement imposed by the 50% test. But the 80% test also insures that the more-than-50-percent shareholder control group can obtain additional control in those instances where a greater interest is needed without the necessity of dealing with a large number of other shareholders (see Pet. App. 40a, Smith, J., dissenting). Thus, contrary to Judge Webster's dissenting opinion in *T.L. Hunt, Inc.* v. *Commissioner*, *supra*, 562 F.2d at 537, it is *both* the smallness of the number of persons in each corporation as well as the sameness of some of those persons that is significant. As the Second Circuit put it in *Allen Oil Co.* v. *Commissioner*, *supra*, 614 F.2d at 340, "the 80% test is designed to assure that within the group of five persons or fewer the overall control of or financial interest in each of the corporations will beyond question be substantially more than 50% (*i.e.*, 80%), whereas the 50% test is intended to assure that there will be a minimum commonality or community of interest between members of the five or fewer persons in control; otherwise there might be no tie between persons controlling one corporation and those controlling another."

b. Nor is there any convincing basis for the view expressed below that "[w]hen Congress in 1969 expanded the definition of brother-sister controlled corp-

orations to cover situations where up to five people owned 80 percent of the stock, it is reasonable to assume that it intended to build on the previous law, changing only the number of persons whose stock interests would be considered and not the nature of those interests" (Pet. App. 35a; Friedman, Ch. J., concurring). To be sure, in the pre-1969 version of the statute, the stock of only one person could be taken into account. That single person had to own 80% of the stock of each corporation to trigger the statute. Hence, 80% of identical, or overlapping, ownership was necessarily present in a controlled group. But once the number of shareholders was increased to five and the 50% test of subparagraph (B) was added to the statute, the required overlap was necessarily reduced from 80% to 50%. The statute as presently drawn cannot be construed to contain an 80% overlapping identical control requirement.

Indeed, the Court of Claims' own construction, which would have reached the opposite conclusion had Richard Crain owned a single share of Vogel Popcorn, does not require the existence of the 80% overlapping control requirement that it asserts Congress intended to preserve by the 1969 amendment. Consider the following example: Corporations X and Y have the following shareholders with the following percentages of stock:

	X	Y
A	51%	51%
B	2%	9%
C	2%	40%
D	25%	—
E	20%	—
Total	100%	100%

Under the Treasury Regulation, both the 80% and the 50% tests are met; under the decision below the 80% test is not satisfied. But if shareholder C transfers only one share of Y corporation to D, the Court of Claims would consider the 80% test met because the same four shareholders (A, B, C, and D) would contribute to each test, even though there is only the same 55% overlapping control as before the transfer. Put another way, once the 50% overlapping identical control test was introduced in subparagraph (B), the 80% requirement of the previous statute was necessarily eliminated. Hence, apart from the fact that there is no legislative history to support the hypothesis that Congress intended to "build on the previous law," it is also demonstrably erroneous.

In sum, the plain language of Section 1563(a) and its legislative history support the governing Treasury Regulations as a reasonable and contemporaneous interpretation of the statute that is consistent with Congress' intent to disallow multiple surtax exemptions of those corporate groups operated as a single economic entity. The requirement by the decision below that Richard Crain had to own at least a single share of Vogel Popcorn for the statute to apply makes no sense, as a matter of logic, or economics. Although the Court of Claims' alternative interpretation may be thought to serve plausible policy goals, respondent "needs more than a plausible policy argument to prevail here" (*National Muffler Dealers Ass'n* v. *United States*, *supra*, 440 U.S. at 488) in the face of the Commissioner's Regulation. "The choice among reasonable interpretations is for the Commissioner, not the courts" (*ibid.*). Hence, the posture of this case is

analogous to that of *National Muffler Dealers Ass'n*, where the Court stated, in terms that equally support our submission here (440 U.S. at 484):

> In short, while the Commissioner's reading of § 501(c)(6) perhaps is not the only possible one, it does bear a fair relationship to the language of the statute, it reflects the views of those who sought its enactment, and it matches the purpose they articulated. It evolved as the Commissioner administered the statute and attempted to give to a new phrase a content that would reflect congressional design. * * * *The Commissioner's view therefore merits serious deference.* [Emphasis added.]

CONCLUSION

For the reasons stated, the judgment of the Court of Claims should be reversed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SECTION 11 [as amended by Revenue Act of 1964, Pub. L. No. 88-272, Section 121, 78 Stat. 25, and Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(b)(2)(B), 83 Stat. 602]. TAX IMPOSED.

* * * * *

(d) *Surtax Exemption*—For purposes of this subtitle, the surtax exemption for any taxable year is * * *, except that, with respect to a corporation to which section 1561 or 1564 (relating to surtax exemptions in case of certain controlled corporations) applies for the taxable year, the surtax exemption for the taxable year is the amount determined under such section.

* * * * *

SECTION 1561 [as added by Revenue Act of 1964, Pub. L. No. 88-272, Section 235(a), 78 Stat. 116, and amended by Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(a)(1), 83 Stat. 599]. LIMITATIONS ON CERTAIN MULTIPLE TAX BENEFITS IN THE CASE OF CERTAIN CONTROLLED CORPORATIONS.

(a) *General Rule.*—The component members of a controlled group of corporations on a December 31 shall, for their taxable years which include such December 31, be limited for purposes of this subtitle to—

(1) one * * * surtax exemption under section 11(d),

(2) one $100,000 amount for purposes of computing the accumulated earnings credit under section 535(c)(2) and (3), and

(3) one $25,000 amount for purposes of computing the limitation on the small business deduction of life insurance companies under sections 804(a)(4) and 809(d)(10).

The amount specified in paragraph (1) shall be divided equally among the component members of such group on such December 31 unless all of such component members consent (at such time and in such manner as the Secretary or his delegate shall by regulations prescribe) to an apportionment plan providing for an unequal allocation of such amount. The amounts specified in paragraphs (2) and (3) shall be divided equally among the component members of such group on such December 31 unless the Secretary or his delegate prescribes regulations permitting an unequal allocation of such amounts.

* * * * *

SECTION 1563 [as added by Revenue Act of 1964, Pub. L. No. 88-272, Section 235(a), 78 Stat. 120, and amended by Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(c), 83 Stat. 602]. DEFINITIONS AND SPECIAL RULES.

(a) *Controlled Group of Corporations.*—For purposes of this part, the term "controlled group of corporations" means any group of—

* * * * *

(2) *Brother-Sister-Controlled Group.*—Two or more corporations if 5 or fewer per-

sons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing—

(A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and

(B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.

* * * * *

Treasury Regulations on Income Tax (26 C.F.R.):

§ 1.1563-1 *Definition of controlled group of corporations and component members.*

(a) *Controlled group of corporations.*—(1) *In general.* For purposes of sections 1561 through 1563 and the regulations thereunder, the term "controlled group of corporations" means any group of corporations which is either a "parent-subsidiary controlled group" (as defined in subparagraph (2) of this paragraph), a "brother-sister controlled group" (as defined in subparagraph 3 of this paragraph, a "combined group" (as defined in subparagraph (4) of this para-

graph), or an "insurance group" (as defined in subparagraph (5) of this paragraph). For the exclusion of certain stock for purposes of applying the definitions contained in this paragraph, see section 1563(c) and § 1.1563-2.

* * * * *

(3) *Brother-sister controlled group.* (i) The term "brother-sister controlled group" means two or more corporations if the same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of the rules contained in paragraph (b) of § 1.1563-3) singly or in combination, stock processing—

* * * * *

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No. 80-1251

In the Supreme Court of the United States

October Term, 1980

UNITED STATES OF AMERICA,
Petitioner,

v.

VOGEL FERTILIZER COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR VOGEL FERTILIZER COMPANY

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THE QUESTION PRESENTED FOR REVIEW

The question presented for review is whether Vogel Fertilizer Company, the Respondent, and Vogel Popcorn Company must be considered as a "brother-sister controlled group" under Section 1563(a)(2) of the Internal Revenue Code of 1954 (26 U.S.C.) for purposes of limiting or denying, as the case may be, to Vogel Fertilizer Company the full corporate surtax exemption otherwise available under Section 11(d).

This question is in turn dependent upon whether a person's stock ownership can be considered for purposes of the 80-percent test under Section 1563(a)(2)(A) when that person does not own stock in each corporation comprising the alleged brother-sister controlled group. The resolution of this question is directly dependent upon whether Treas. Reg. § 1.1563-1(a)(3) is valid despite its effect of unilaterally and unreasonably expanding the scope of Section 1563 beyond that intended by Congress.

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STATUTE AND REGULATIONS

The relevant portions of Sections 11(d), 1561(a), 1562, 1563(a)(2), and 1564(a) of the Internal Revenue Code of 1954 (26 U.S.C.),[1] and of Treasury Regulation, Section 1.1563-1(a)(1) and (3), and Section 1.1551-1(e)(1) and (3) (26 C.F.R.), are set forth in the Appendix, *infra*, 1a-10a.

STATEMENT OF THE CASE

1. Respondent Vogel Fertilizer Company ("VFC"), an Iowa corporation with offices and principal place of business located in Hamburg, Iowa, sells agricultural fertilizer products at retail to local customers. For all relevant periods of time, all of the issued and outstanding stock in VFC was held by the following persons in the amounts and percentages as indicated opposite each name:

Vogel Fertilizer Company

Common Stock Owner	No. of Shares	Percent
Arthur Vogel	113,575	77.49%
Richard Crain	33,000	22.51%
	146,575	100.00%

VFC had no preferred stock or other class or classes of stock authorized or issued. (Pet. App. 2a).

2. Vogel Popcorn Company ("VPC"), an Iowa corporation with offices and principal place of business also located in Hamburg, Iowa, is engaged in the business of wholesaling and retailing popcorn. For all relevant periods of time, all of the issued and outstanding stock in VPC was held by the following shareholders in the amounts and percentages indicated opposite each name:

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1 Unless otherwise noted, the Internal Revenue Code of 1954 (26 U.S.C.) will hereinafter be referred to as "IRC."

Vogel Popcorn Company

Shareholder	No. of Shares	Voting % of All Classes Entitled to Vote	Percent of Value of All Classes of Stock 1973	1974	1975
Arthur Vogel	440,062 Common Stock	87.5%	90.66%	91.42%	93.42%
Arthur Vogel, Trustee of Alex Vogel Family Trust	62,866 Voting Preferred Stock, $1 Par	12.5%	9.34%	8.58%	6.58%

VPC had no other stock authorized or issued. (Pet. App. 2a).

3. For purposes of this case, the stock held by either Richard Crain and Arthur Vogel in VFC cannot be attributed to the other under the attribution rules of IRC § 1563(d). Furthermore, and under the same rules of attribution, Arthur Vogel, as an individual, cannot be considered as the constructive owner of the VPC shares held by him as Trustee. (Pet. App. 2a).

4. VFC's original tax returns were filed based on the incorrect assumption that VFC and VPC constituted a brother-sister controlled group of corporations, a conclusion required under the applicable Treasury Regulations. Treas. Reg. § 1.1563-1(a)(3). Therefore, on its original returns VFC did not utilize a full surtax exemption, but rather elected for 1973 and 1974 to utilize the multiple surtax penalty (IRC §§ 1562 and 1564(a)) and the multiple surtax penalty (IRC § 1562(b)). For 1975, VFC elected to utilize a "shared" surtax exemption ("shared" with VPC by VPC taking the entire surtax exemption, pursuant to IRC § 1561(a)(2)). (Pet. App. 2a-3a).

5. On January 26, 1976 (after VFC had filed its returns for the years in question), the United States Tax Court filed its decision in *Fairfax Auto Parts of Northern Virginia, Inc. v. Commissioner*, 65 T.C. 798 (1976), *rev'd per curiam*, 548 F.2d 501 (4th Cir. 1977),

cert. denied, 434 U.S. 904 (1977) [hereinafter cited as *Fairfax*]. In *Fairfax*, the Tax Court held in a case of first impression that Treas. Reg. 1.1563-1(a)(3) constituted "a totally unwarranted extension of both the statutory language of Section 1563(a)(2) and the underlying congressional intent," and as such was invalid. *Fairfax*, 65 T.C. at 802-803. Based on this then-new authority, VFC subsequently filed timely claims for refund. VFC asserted in its claims for refund that it and VPC were not members of a controlled group of corporations, and that therefore VFC was entitled to a full surtax exemption for each taxable year. After the Internal Revenue Service disallowed VFC's claims because of Treas. Reg. § 1.1563-1(a)(3) despite the holding in *Fairfax*, VFC commenced this refund lawsuit in the United States Court of Claims. (Pet. App, 3a).

6. The United States Court of Claims, with a dissenting opinion, agreed that VFC should be entitled to a separate surtax exemption, holding Treas. Reg. § 1.1563-1(a)(3) "invalid to the extent that it counts stock held by a shareholder in only one corporation of the group of corporations toward the 80-percent requirement in Section 1563(a)(2)(A)." (Pet. App. 34a).

SUMMARY OF ARGUMENT

1. The Court of Claims has correctly determined that Vogel Fertilizer Company and Vogel Popcorn Company are not members of a "brother-sister controlled group" under IRC § 1563(a), and that Vogel Fertilizer Company is therefore entitled to a full surtax exemption for each of the years in question. The Court of Claims reached this result by determining that Richard Crain's stock ownership in Vogel Fertilizer Company could not be counted for purposes of the 80-percent test of IRC § 1563(a)(2)(A), since he did not have any interest in Vogel Popcorn Company. Under this interpretation of the 80-percent test, the 77.49% stockholdings of the remaining shareholder (Arthur Vogel) were not sufficient to satisfy the 80-percent test. Thus, the two corporations

could not be deemed members of a controlled group of corporations under IRC § 1561.

2. The issue is whether the 80-percent test of IRC § 1563(a)(2) requires a person to have an ownership interest in each member of the alleged brother-sister controlled group before his stock ownership can be counted for purposes of that test, i.e., the principle of common ownership. The conclusion reached by the Court of Claims, Fifth Circuit (*Delta Metalforming Co., Inc. v. Commissioner, 632 F.2d 442 (5th Cir. 1980), cert. pending* No. 80-1499 (filed March 4, 1981) [hereinafter cited as *Delta Metalforming*]), and Tax Court (*Fairfax*) that the principle of common ownership *is* applicable under the 80-percent test of IRC § 1563(a)(2), and that the rule to the contrary in Treas. Reg. § 1.1563-1(a)(3) is to that extent invalid as an "unreasonable and inconsistent" regulation, is supported by the legislative history and purpose of the statute.

The original purpose of the surtax exemption enacted in 1950 was to reduce the tax burden on small businesses. IRC § 1563(a)(2) was enacted in 1964, and amended in 1969, to meet the specifically perceived problem of large corporations subdividing into several smaller, but still integrated, corporations simply to obtain a lower effective tax rate because of the availability of multiple exemptions by such action. The purpose behind IRC § 1563(a)(2), then, was to design a statutory scheme which both identified the "small" corporations which were actually components of much larger business units, while still affording the benefit of the surtax exemption to those "bona fide" small businesses that Congress always intended to benefit and stimulate. This design can only be carried out if (contrary to the Government's position) the principle of common ownership is part of the 80-percent test, since the only means of discovering the links between the subdivided portions of the large entity is by means of the financial interest the "large entity" has in the smaller parts of the whole. Since an individual can only have a financial

interest in a corporation if he owns stock therein, to take into consideration under the 80-percent test an individual who does not own stock in each member of the alleged control group defeats this statutory design of Congress.

That the mere expansion of the ownership group from one (in the 1964 version of the statute) to five was not intended to have the effect of abandoning the common ownership or financial interest principle, as the Government argues, is implicit from an examination of the transition of the Government's interpretation of the 80-percent test from enactment in 1964 to amendment in 1969. The original 80-percent test was recognized even by the Government to require common ownership. If the Government had interpreted the original test otherwise, as it now urges the current test to be interpreted, a ludicrous situation would have resulted where all existing corporations with sole shareholders would have been combined into one gigantic controlled group. With the drafting of Treas. Reg. § 1.1563-1(a)(3), the Government abandoned the principle of common ownership. However, there is nothing in the history of the 1969 amendment to show that this major change was intended. All that was changed in the 80-percent test was to increase the ownership group from one to five. Logically, this change should not have affected the application of the principle of common ownership as it had been applied since 1964. If Congress had meant to abandon this key principle in 1969, it surely would have indicated such in unmistakable terms. It did not, however, and therefore the regulation is clearly excessive in bringing to bear a rule change never contemplated by Congress.

Indeed, the only available contemporaneous explanation of the 1969 amendments to IRC § 1563(a)(2), the Treasury's own carefully considered "General Explanation" and "Technical Explanation" (upon which Congress placed great reliance) confirms that a financial interest by each person in the "five or fewer" group

was required before they could be included in the 80-percent test. Among other items, the very wording of the explanation by the Treasury, plus the fact that no example was provided similar to that in Treas. Reg. § 1.1563-1(a)(3) to illustrate what would have been a significant change in the scope of the law, seriously undermines the Government's position.

Thus, it is submitted that Congress intended that the purpose of the 80-percent test was to require an aggregate ownership which represented substantially the entire financial interest of all involved corporations. The purpose of the 50-percent test, which is secondary to the 80-percent test, was to permit corporations with widely differing holdings of stock to fall outside the controlled group, since such a situation would make it difficult to effectively control the corporations as one. The Government's interpretation set forth in Treas. Reg. § 1.1563-1(a)(3), however, renders the 80-percent test irrelevant. If control is found under the 50-percent test, what does the Government's requirement that an additional 30 percent of control be owned by someone else really add? Congress could just as well have then had only one test, rather than the two it provided. Such an interpretation does not give the 80-percent test the status intended by Congress, and as such the Regulation is clearly unreasonable and inconsistent with Congressional intent. Only when the 80-percent test is viewed as a measure of financial interest do *both* tests become meaningful, one measuring control and one measuring the level of financial interest.

Equitable considerations also exist to indicate that the interpretation of the 80-percent test in Treas. Reg. § 1.1563-1(a)(3) is incorrect. Let us suppose that two individuals formed a corporation, with individual A owning 50 percent and B owning 50 percent. Individual B would have entered into this arrangement assuming that the corporation would have the benefit of the surtax exemption. However, unbeknown to B, individual A subsequently and independently creates a second cor-

poration, 100 percent owned by A, in order to enter into a second business. Under the Government's interpretation of IRC § 1563(a)(2), the full surtax exemption is lost to the first corporation and B, a result not reached under the Court of Claims' rationale. Surely Congress did not intend that such an unfair surprise be visited upon individual B, i.e., Richard Crain, under what must be a common fact pattern, because of actions taken by an individual over whom he has no control. Thus, it is all the more clear that the Government's interpretation of IRC § 1563(a)(2) is unreasonable and inconsistent with Congressional intent.

3. IRC § 1563(a)(2) sets forth the definition of a "brother-sister controlled group" as any group of:

> "[T]wo or more corporations if *5 or fewer persons* . . . own . . . stock possessing —
>
> (A) at least 80 percent of the . . . stock of each corporation, *and*
>
> (B) more than 50 percent of the . . . stock of each corporation, taking into account the stock ownership of *each such person* only to the extent such stock ownership is identical with respect to each such corporation." (Emphasis added).

When the significant words of IRC § 1563(a)(2) are analyzed using well-established and commonly used guidelines of English grammar and usage, the conclusion reached is that the Tax Court (*Fairfax*), Fifth Circuit (*Delta Metalforming*), and the Court of Claims herein were correct in requiring for purposes of the 80-percent test the principle of common ownership. First, the statutory phrase "five or fewer persons" is the conjunctive subject of both the 80- and 50-percent tests. In order to be considered part of the ownership group for the 50-percent test, one must own stock in each corporation involved. "If ownership of stock in each corporation involved is a precondition to membership in the owner-

ship group for purposes of the 50-percent test, and the ownership groups for the 50-percent test and 80-percent test are one and the same, it follows . . . that one must own stock in each corporation before his stock can be taken into account for purposes of the 80-percent test." *Fairfax*, 65 T.C. at 803 (1976).

Second, the "last antecedent doctrine" establishes that the clause "each such person" under the 50-percent test directly refers back to the same "5 or fewer persons" being reviewed under the 80-percent test. The use of term "each" [such person] must mean that "each person — and not just some of the persons — counted for purposes of the 80-percent test must also be counted for purposes of the 50-percent test." *Fairfax*, 65 T.C. at 803 (1976). Moreover, the commonly understood definitions of the particular statutory terminology used in IRC § 1563(a)(2) support a reading that requires the principle of common ownership under the 80-percent test. The very title and subtitles of the statute "contemplates a relationship of close ties and common connections . . . ." and "underscore the common connections, interrelationships and mutual influences of the group." *Delta Metalforming*, 632 F.2d at 446.

Thus, the result obtained to the contrary by the Government's "natural reading" theory of statutory construction (and the interpretation of IRC § 1563(a)(2) advanced by Treas. Reg. § 1.1563-1(a)(3)) is erroneous and plainly inconsistent with the statutory language of IRC § 1563(a)(2). It can only be assumed that Congress intended to follow the rules of good grammar and English usage when drafting IRC § 1563. Therefore, the result obtained from the application of such rules, that is, the requirement of common ownership under the 80-percent test, must be the result intended by Congress.

4. The principle of deference to the regulatory efforts of the Commissioner is designed so as "to set the framework for judicial analysis: it does not displace it." *United States v. Cartwright*, 411 U.S. 546 at 551 (1973). Where a

regulation, as here, is clearly unreasonable and "creates a rule out of harmony with the statute . . . ," it must be held invalid, as the Court of Claims recognized. *Manhattan General Equipment Co. v. Commissioner*, 297 U.S. 129, 134 (1936). Simply "because [the Commissioner] has a choice of alternatives, his choice should [not] be sustained where the alternative chosen is unrealistic." *United States v. Cartwright*, 411 U.S. *supra* at 557. The Commissioner cannot be allowed to rewrite, add to, and expand the statute beyond that intended by Congress, as he has attempted in Treas. Reg. § 1.1563-1 (a)(3). *United States v. Calamaro*, 345 U.S. 351 (1957).

Accordingly, since Treas. Reg. § 1.1563-1(a)(3) has been shown to be unreasonable, inconsistent with the intent of Congress, and outside the authority of the Commissioner, the normal policy of "deference" is not appropriate. Treas. Reg. § 1.1563-1(a)(3) simply is not worthy of the respect usually so granted to the Commissioner's regulations.

ARGUMENT

For a person's stock ownership to be taken into account for purposes of the 80-percent test of Section 1563(a)(2)(A), that person must own stock in each member of the alleged brother-sister controlled group. Since Treas. Reg. § 1.1563-1(a)(3) clearly advances a contrary rule, it is invalid as an impermissible and unreasonable expansion of the statute beyond that intended by Congress.

The legal question presented by this case is whether Vogel Fertilizer Company (hereinafter "VFC") and Vogel Popcorn Company (hereinafter "VPC") may be considered a "brother-sister controlled group" under IRC § 1563(a)(2). If VFC and VPC are not members of such a controlled group, as the Court of Claims found, then it is undisputed that VFC is entitled to a full surtax exemption for each taxable year in question, as as-

serted in the claims for refund filed by VFC.[2]

A. The Treasury Regulation is inconsistent with the intent of Congress, and is a clearly unreasonable interpretation of Section 1563(a)(2) when the legislative history and purpose of the statute is considered.

1. IRC § 1563(a)(2) defines a "brother-sister controlled group" of corporations as any group of:

> "Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing —
>
> (A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and
>
> (B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each cor-

2 The legal question arises from the corporate income tax provisions of the Internal Revenue Code of 1954. During the taxable years in question, a corporation's income tax was equal to the sum of a "normal tax" (IRC § 11(b)) and a "surtax" computed under IRC § 11(c). The surtax for the years in question was equal to 26 percent of the amount by which corporate taxable income exceeded a "surtax exemption" for the taxable year. IRC § 11(c). For VFC's taxable years ending in November 30, 1973 and 1974, the surtax exemption was $25,000; for the year ending November 30, 1975, the surtax exemption was $50,000. IRC § 11(d), as amended by Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(b)(2)(B), 83 Stat. 602, and as amended by Tax Reduction Act of 1975, Pub. L. No. 94-12, Section 303(b), 89 Stat. 26. If a corporation was determined to be a member of a controlled group of corporations, then as a general rule the surtax exemption for that corporation was equal to a particular share of a single surtax exemption. This share was established either by agreement among the members of the controlled group, or was an equal share

> poration, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation."

Thus, two separate tests, i.e., a "50-percent identical interest-control test" and an 80-percent "financial interest test," must both be met before a corporation will be included within the definition of a brother-sister controlled group.

Under IRC § 1563(a)(2)(B), the 50-percent test is met when the stockholdings in VFC and VPC of one stockholder, Arthur Vogel, are considered:

VFC and VPC 50-Percent
Identical Interest Test

	VFC	VPC	Identical Interest
Arthur Vogel	77.49%	87.5%	77.49%
Arthur Vogel, Trustee	0%	12.5%	0%
Richard Crain	22.51%	0%	0%
Total Identical Interest:			77.49%

To qualify VFC and VPC as a brother-sister controlled group, however, the 80-percent test must also be satisfied. The question presented for review, and the source of the dispute between VFC and the Government, is in the application of the 80-percent test to the stockholdings of VFC and VPC. More specifically, the

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of the exemption as divided among the entire group. IRC § 1561. During 1973 and 1974, however, members of a controlled group could, at their option, elect "multiple surtax exemption" treatment. IRC § 1562. (VFC made such an election in 1973 and 1974.) This meant, in effect, that a corporation, even though a member of a controlled group, could elect to utilize an entire single surtax exemption in computing its tax, but with the proviso that a "penalty" equal to 6 percent of its first $25,000 of taxable income would be added to its income tax. For 1973, the maximum allowable surtax exemption under the multiple surtax exemption was $12,500; in 1974, the multiple surtax exemption was $8,333. IRC § 1564(a)(1).

question is whether Richard Crain's stock ownership can be taken into account during the process of finding the "5 or fewer persons" who own 80 percent of VFC, when he does not have any ownership interests in VPC.[3] The Government would count Mr. Crain's stock on the basis of its Regulation, while VFC would not. These contrasting positions are illustrated by the following tables:

VFC's Application of 80-Percent Test
(Percentage of Voting Stock Owned)

	Arthur Vogel	Arthur Vogel, Trustee	Richard Crain	Total Ownership of Stockholders Owning Stock in Both Corporations
VFC	77.49%	0%	22.51%	77.49% (80% test *not* satisfied)
VPC	87.5 %	12.5%	0%	87.5 %

Government's Position, 80-Percent Test
(Percentage of Voting Stock Owned)

	VFC	VPC
Arthur Vogel	77.49%	87.5%
Arthur Vogel, Trustee	0%	12.5%
Richard Crain	22.51%	0%
80-Percent Test:	100.00%	100.0%

2. There is no doubt that the Treasury Regulation comes to a conclusion contrary to VFC's interpreta-

3 The question at issue herein has been the topic of considerable litigation, the result of which is that the Tax Court, Court of Claims, and Fifth Circuit have all held that Treas. Reg. § 1.1563-1 (a)(3) is invalid and that a person must own stock in each corporation to be counted under the 80-percent test. Three Circuit Courts of Appeal, however, have held to the contrary, i.e., the Fourth Circuit, Second Circuit, and Eighth Circuit. *See, e.g., Fairfax Auto Parts of Northern Virginia, Inc. v. Commissioner*, 65 T.C. 798 (1976), *rev'd per curiam*, 548 F.2d 501 (4th Cir. 1977), *cert. denied*, 434 U.S. 904 (1977); *T. L. Hunt, Inc., of Texas v. Commissioner*, T.C.M. (CCH) 1976-221 (1976), *rev'd*, 562 F.2d 532 (8th Cir. 1977); *Charles Baloian Company, Inc. v. Commissioner*, 68 T.C. 620 (1977), *appeal pending* (9th Cir. 1978); *Delta Metalforming Co., Inc. v. Commissioner*, T.C.M. (CCH) 1978-354 (1978), *aff'd* 632 F.2d 442 (5th Cir. 1980); *Allen Oil Company, Inc. v. Com-*

tion of the statute. There is also no doubt that the Government places great reliance upon that conclusion (self-serving though it may be in view of the fact that the Government has created its own "authority" by drafting the regulation). The Court of Claims, however, found the Government's reliance on Treas. Reg. § 1.1563-1 (a)(3) to be misplaced, as the regulation was "clearly inconsistent with the legislative history and unreasonable when the purpose, as well as the bare words, of the statute are considered." (Pet. App. 12a and 28a). *See also, Fairfax*, 65 T.C. 798 (1976); *Delta Metalforming*, 632 F.2d 442 (5th Cir. 1980). If the Court of Claims, Tax Court, and Fifth Circuit are correct, as VFC believes is the case, and the Regulation is invalid, then the Government's statutory analysis must also be invalid, as the two go hand-in-hand in stating the same rule.

Treas. Reg. § 1.1563-1(a)(3) defines a "brother-sister controlled group" in a manner significantly different from the language of IRC § 1563(a)(2) by adding the words "singly or in combination" to the statutory definition.[4] Under the Regulation, a brother-

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missioner, T.C.M. (CCH) 1979-88 (1979), *rev'd*, 614 F.2d 336 (2nd Cir. 1980); *Davidson Chevrolet Co. and Monte Zinn Chevrolet Co.*, T.C.M. (CCH) 1979-414 (1979), *appeal pending* (6th Cir. 1980); *Jacqueline, Inc. v. Commissioner*, T.C.M. (CCH) 1977-340 (1977). Indeed, even where the Tax Court is bound by the *Golsen* rule (requiring it, by its own rules, to follow precedent established by the Circuit Court of Appeals to whom a case would be appealed, *Golsen v. Commissioner*, 54 T.C. 742 (1970), the Tax Court maintains that Treas. Reg. § 1.1563-1(a)(3) is invalid. *See, e.g., Dixie Realty Co., Inc.*, T.C.M. (CCH) 1980-297 (1980).

4 It is interesting to note the ease with which the Treasury modified the statutory language of IRC § 1563(a)(2) to clearly indicate that the principle of common ownership should not be a part of the 80-percent test. The very ease of this modification, i.e., the addition of only four words to the statute, indicates that if Congress had intended to so eliminate the requirement of common ownership from the 80-percent test, it certainly could have easily and clearly done so. The fact that Congress did

sister controlled group exists where there are two or more corporations if:

> "... the same five or fewer persons ... own ... *singly or in combination*, stock possessing —
>
> (a) At least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation; and
>
> (b) More than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation." (Emphasis added). Treas. Reg. § 1.1563-1(a)(3).

Example 1 of the Regulation further illustrates the Treasury's belief that the 80-percent test does not require common ownership of stock in each corporation, and would therefore require Richard Crain's stockholdings in VFC be counted toward that test, even though he does not have any interest in VPC. Treas. Reg. § 1.1563-1(a)(3)(ii).

It is clear that the Regulation represents a totally

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not take such a step was recognized by the Fifth Circuit as an important factor:

> "Further, if Congress had intended to change the requirement of sameness or common ownership, it certainly knew how to do so. See Thomas, 28 Tax L. Rev. at 79 ('One thing is certain: If Congress had intended the interpretation adopted by the regulation, it could have drafted a statute which stated it more accurately.). Indeed, it seems to us that the Treasury — who originally endorsed the 1969 amendment and on whom congressional committees extensively rely — would have suggested language (such as that used in their subsequent corollary regulation) had it intended to reject the common ownership requirement." *Delta Metalforming*, 632 F.2d at 448.

impermissible construction of the statutory language when an analysis is made of the transition of the interpretation of the 80-percent test from enactment in 1964 through amendment in 1969. Prior to amendment by the Tax Reform Act of 1969, there is no doubt that IRC § 1563(a)(2) was written and interpreted by the Government so as to apply only in those situations where at least 80-percent of *each* corporation in the brother-sister controlled group was owned by the *same one person*, i.e., the principle of common ownership. IRC § 1563(a)(2) (as added by Revenue Act of 1964, Pub. L. 88-272, § 235(a), 78 Stat. 19). (See Appendix, *infra.*). (If the Government *had* interpreted the 1964 version in the manner it is urging that the present 80-percent test should be interpreted, that is, absent the principle of common ownership, it would have resulted in the ludicrous situation of combining all existing corporations with sole shareholders into one gigantic controlled group.) In 1969, even the Government recognizes that the *only* change made to the 80-percent test was to expand the group of one to a maximum of five. No other change was made or implied to the 80-percent test. Logically, and absent any indication to the contrary by Congress, the mere increase in the size of the ownership group should not have therefore affected the continued application of the principle of common ownership. This can then only be taken as authority for now permitting the 80-percent test to be satisfied only where the now larger number of the same persons comprise the ownership group of, and have interests in, each corporation. Treas. Reg. § 1.1563-1(a)(3) clearly exceeds that authority.

As support for this conclusion, it should be pointed out that the Government certainly has not been able to demonstrate, and cannot demonstrate, that Congress ever intended to abandon the requirement present in the 1964 statute that the individuals in control must have a financial interest in *each* corporation when it expanded the ownership group from the one required in the old version to the five required now. The Fifth Circuit's reasoning on this point is particularly persuasive:

> "*There is nothing in the legislative history to suggest that the kind of group which would and would not be entitled to the exemption — the 'sameness' — was to be altered.* Absent a clear indication to the contrary, it is reasonable to assume that the persons within the control group would continue to constitute the ownership group of each corporation. The House and Senate Reports do not indicate any intention to change the constituents of the ownership group. Indeed, all of the examples submitted to Congress by the Treasury to illustrate the operation of the exemption involve shareholders who own stock in each corporation. *The absence of contrary examples strongly suggest that the Treasury did not contemplate the definition of the 80% test group by strangers to the 50% test group.*" *Delta Metalforming*, 632 F.2d at 448. (Emphasis added).

See also, T. L. Hunt, Inc. v. Commissioner, supra, 562 F.2d at 537 (Webster, J., dissenting); Libin and Abramowitz, *Multiple Corporations: A Surprising Interpretation of Sec. 1563(a)(2) in Temporary Regulations*, 3 *TAX ADVISER* 326 (1971).

Indeed, as suggested by the Fifth Circuit and more fully explained by the Court of Claims, the Treasury's own carefully considered explanation of the change ultimately put into law by the Tax Reform Act of 1969 confirms that a financial interest by each of the "five or fewer persons" in each corporation was to remain a requirement. The Court of Claims, after a full and exhaustive analysis of the entire General Explanation and the Technical Explanation, discarded any attempt by the Government to argue to the contrary, as the Government is attempting to argue with this Court. The Court of Claims set forth in full the entire relevant portions of the Treasury's Technical Explanation and General Explanation, and discussed in detail how the Treasury's own contemporaneous explanation "clearly indicates that each of the five or fewer persons considered under the 80-percent test must hold some stock in each corpora-

tion in the controlled group." (Pet. App. 21a).

The Court of Claims found as most important in such analysis the particular wording used by the Treasury in describing the change in the 80-percent test (Pet. App. 21a, fn omitted):

> "First and foremost, the Treasury explanation directly states this very proposition:
>
> > ***Under the proposal, the present definition would be changed so that a group of corporations would constitute a brother-sister controlled group if (1) the *same five* or fewer persons own at least 80 percent of the voting stock or value of shares of *each* corporation, and (2) *these* five or fewer individuals own more than 50 percent of the voting power or value of shares of *each* corporation considering a particular person's stock only to the extent that it is owned identically with respect to each corporation. [Emphasis added in part.]
>
> "The use of the word 'same' in the above sentence removes any possible ambiguity and establishes that the same persons must own some stock in each corporation. Moreover, the use of the words 'these five or fewer individuals' supports the construction of the statute by the Tax Court in *Fairfax Auto Parts* to the effect that the same persons, with no additions or subtractions, must be considered in both the 80-percent and the 50-percent tests." [Emphasis original].

The Court of Claims also noted the lack of examples that would have illustrated the removal of the requirement of sameness in the 80-percent test as a factor undermining the Government's arguments (Pet. App. 22a-23a, fn omitted):

> "Moreover, if the Treasury was indeed proposing to remove the requirement of sameness in the 80-percent test, it is scarcely credible that an example to

> illustrate this important change would not have been given. In every example in the Treasury explanation involving the 80-percent test, the persons mentioned own some stock in each corporation. The explanation even states in detail that the 80-percent test is met 'whether one person owns 80 percent of the voting stock of each corporation, four persons *each* own 20 percent of the voting stock of each corporation, or one person owns 60 percent of the voting stock of one corporation *and 40 percent of another*, and another person owns 40 percent of the voting stock of the first *and 60 percent of the second*.' [Emphasis supplied.]"

The Court of Claims ended its persuasive analysis of the Treasury's Explanation by noting that the 80-percent test was envisioned in the Explanation, contrary to the Government's current position, as "a test of independent significance, in fact a test of greater significance than the 50-percent test." (Pet. App. 23a):

> "The explanation states in two places that the 50-percent test is added to 'insure' that the corporations are in fact 'controlled' by the group of stockholders as one economic entity or enterprise. The use of the word 'insure' indicates that the 80-percent test also measures to some degree whether the corporations can be considered one economic entity. The 80-percent test therefore must measure substantial overlapping financial interests. The 50-percent test was added to 'insure,' not to establish, the unity of economic enterprise by measuring whether overlapping control exists.
>
> "Similarly, the explanation states: 'Thus, even where the 80 percent ownership test is met, the brother-sister definition will not apply unless the stockholdings of the individuals in the various corporations also meet the 50-percent identical ownership test.' The emphasis of the sentence on the 80-percent test as the primary requirement belies

> the notion that the 80-percent test was intended to measure only the number of stockholders and not the extent of overlapping stock ownership. The Treasury explanation is totally inconsistent with the relatively minor role relegated to the 80-percent test by Treas. Reg. § 1.1563-1(a)(3)."

The Court of Claims concluded (Pet. App. 24a):

> "In conclusion, we find no ambiguity whatsoever in the Treasury explanation and other legislative material when they are read in their entirety. It would be a gross usurpation of the power of Congress to draft tax statutes to allow the Treasury to explain a legislative proposal in one way and then to interpret it after enactment in a far more expansive fashion."

This analysis, it is submitted, is persuasive, and illustrates why the Government has difficulty rebutting it in their arguments on this point. *See, e.g., Petitioner's Brief* at p. 27-31.

Furthermore, since the single individual under the original definition of IRC § 1563(a)(2) could have controlled for most business purposes each corporation in the brother-sister group with simply a 50-percent ownership of each corporation's stock, Congress, it seems, must have been striving after something more than the simple control (or, as the Government describes it, "closely held") test when it adopted the present-day 80-percent test. *See*, Thomas, *Brother-Sister Multiple Corporations — the Tax Reform Act of 1969 Reformed by Regulation, 28 TAX L. REV.* 65, at 79-83. The 80-percent test, it is submitted, was designed to require an aggregate ownership which represents substantially the entire *financial* interest in all corporations involved. *See, T. L. Hunt, Inc. v. Commissioner*, 562 F.2d 532, 537 (8th Cir. 1977) (Webster, J., dissenting); Thomas, *Brother-Sister Multiple Corporations — the Tax Reform Act of 1969 Reformed by Regulation*, 28 *TAX L. REV.* 65, at 82 (1972). This design for the 80-percent test gives it a different function from the 50-percent test of IRC § 1563

(a)(2)(B), since it is clearly undisputed even by the Government that the 50-percent test is one of control, based on its requirement of "identical interests." (*Petitioner's Brief* at p. 15). (Furthermore, this function differs radically from the function the Government would attach to the 80-percent test, i.e., assuring a "closely held" status. (*Petitioner's Brief* at p. 35).)

In fact, it is clear that the only purpose behind the then new, additional 50-percent test of § 1563(a)(2)(B) was to permit corporations that were 80 percent commonly owned, but in widely differing proportions, to fall outside the definition of a controlled group by ultimately focusing on only the "identical" ownership interest of each person in each corporation.[5] Yet the regulations actually utilize the 50-percent test, rather than the 80-percent test, to measure not only identical ownership, but common ownership in the first instance. A recent article effectively further discusses this point as follows:

> "As expressed by Treasury's General Explanation, the original 80 percent test ownership group was to be expanded from one individual to five or fewer to avoid the potential for easy avoidance of the original control test where the actual ownership group was larger than one individual, yet was still small enough that the corporations involved could be effectively manipulated as if they were one. The 50 percent test was added to insure that the application of the expanded definition was restricted to only those cases where the ownership group held their 80 percent in such a way as to permit them to in fact control the group of corporations as a single econo-

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5 It is clear that the 80-percent test can be met while the 50-percent test failed under such circumstances when the following example given by the Court of Claims is considered: the stock of one corporation is owned 80 percent by A and 20 percent by B. The stock of another corporation is owned 20 percent by A and 80 percent by B. "The 80-percent test is met regardless of which interpretation is correct. The 50-percent test would not be met . . . ." since there exists only a 40% identical interest." (Pet. App. 8a, fn3).

> mic enterprise. If Congress had intended to require only that the ownership group maintained control over the corporations in the controlled group, the 50 percent test would have been sufficient to accomplish that objective since, theoretically, control may be exercised by those individuals in possession of the majority of the stock. By retaining the 80 percent test, it is apparent that Congress intended to require more than just control. As it had done in the original enactment, Congress intended the individuals in the ownership group to possess a financial interest in each corporation in the controlled group." Student Comment, *Brother-Sister Controlled Groups: Tax Court Stands Firm in the Face of Reversal,* 13 CREIGHTON L. REV. 543 (1979) (citations omitted).

Accordingly, Congress in passing § 1563(a)(2) must have intended that the brother-sister controlled group rules come into effect only when *two* tests are met: that is, (1) when identical stockholders are found having *control* of each corporation (the 50-percent "identical interest" test), *and* (2) when stockholders are found having a sufficient *financial interest* in (the 80-percent "financial interest" test) *each* of the corporations in the alleged controlled group. These are clearly separate functions. Consequently any arguments by the Government that the 80- and 50-percent tests are duplicative or that the 50-percent test is "purposeless" and without a function under the Court of Claim's reasoning must fail.

Therefore, the best reflection of Congress's intent in passing IRC § 1563(a)(2) must be that for a person's stock ownership to be taken into account for purposes of the 80-percent test, that person must have a financial interest in each member of the brother-sister controlled group. An individual can have a financial interest in the operation of a corporation only if he owns stock therein. Consequently, to take into consideration for purposes of the 80-percent test the ownership of an individual who does not own stock in any corporation in the alleged controlled group would defeat the goals and intent of Con-

gress in requiring financial interests by each party in each corporation.

Indeed, the admittance of an individual without financial interests in all the corporations comprising the ownership group pursuant to Treas. Reg. § 1.1563-1(a)(3) acts to render the 80-percent test irrelevant:

> "The 50 per cent test is, as a majority opinion notes, a test of *control.* The use of identical interests for purposes of this test is to identify the degree of control necessary to allow the corporations 'to operate * * * as one economic entity.' The 80 per cent test, on the other hand, is one of *financial interest.* To me, it makes little sense to depart from the language and purpose of this statute by permitting the financial interest test to be satisfied by a different group of five or fewer persons for each one of the companies within the controlled group. *Such a construction renders meaningless the additional 80 per cent test. 'If control (more than 50 per cent ownership) is in a few persons, what is added by a requirement that an additional 30 per cent be owned by someone else?* The presence of the 80 per cent test only makes sense when viewed as a test of *substantial financial interest by the persons in control of the corporations.* In other words, the statute requires that five or fewer persons have common control of two or more corporations and that those same five or fewer persons have at least an 80 per cent financial interest in each corporation.'" *T. L. Hunt, Inc. v. Commissioner,* 562 F2d 532 at 536-537 (Webster, J., dissenting). (Emphasis added.).

Consequently, it can only follow that the 80-percent test is meaningless unless it is applied to only those who have ownership interests in each corporation. The Tax Court further amplified Judge Webster's analysis on this point:

> "By the same token, respondent's interpretation is contrary to the function of the 80-percent test and its

concomitant interrelationship with the 50-percent test. Manifest from the legislative history is the proposition that the 50-percent test is one of control, drawn to insure that the members of the controlled group could be organized and operated as one corporation. Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means, 91 Cong., 1st Sess. 5396 (1969). The 50-percent test being the control test, it is apparent that the 80-percent test is one of *financial interest*. Together, the tests assure that the sanctions imposed by section 1561 are applied only in those instances where the evil sought to be remedied rears its head, i.e., where those in control of two or more corporations are utilizing the multicorporate form to obtain an unwarranted financial benefit. To allow the 80-percent ownership test to be satisfied with stock of a person owning stock in only one corporation, i.e., a person not within the control group, would simply ignore the basic function of the 80-percent test." *Fairfax*, 65 T. C. at 805-806.

Accordingly, it is not the *Fairfax*, Fifth Circuit, and Court of Claims rationale that mangles congressional intent, as the Government would have this Court believe; rather, it is the excessive and overbroad regulating present in Treas. Reg. § 1.1563-1(a)(3). Consequently, this Court is respectfully urged not to allow the regulation in question to impose a limitation on the surtax exemptions for VFC and VPC in violation of what was actually intended in IRC §§ 1561 and 1563. As Judge Webster so aptly points out:

"There is nothing in the legislative history to suggest that Congress intended to penalize companies in which there were five or fewer shareholders. *It is not the smallness of the number of persons in each company that triggers § 1563; it is the sameness of that small number.* The 80 per cent financial interest requirement is meaningless unless it is the same

group of five or fewer persons that own 80 per cent of each company within the controlled group. It is this requirement of 'economic entity' which is entirely eviscerated by Reg. § 1.1563-1(a)(3)." *T. L. Hunt, Inc. v. Commissioner*, 562 F.2d 532 at 537 (Webster, J., dissenting). (Emphasis added.).

3. The Government attempts to draw further support for its arguments from legislative history where it was stated that "the stock ownership test of section 1563 (a)(2) would be the same test employed in Section 1551(b) (2) of the Code." H.R. REP. NO. 413, (Pt. 2), 91st Cong., 1st Sess. 76, 99 (1969). The Government then directs the Court's attention to Treas. Reg. § 1.1551-1 (g)(4), Example 4, which it asserts indicates that common ownership for purposes of the 80-percent test is not required. (*Petitioner's Brief* at p. 31-32). As the Court of Claims noted, however, the examples provided in Treas. Reg. § 1.1551-1 "are capable of more than one interpretation." (Pet. App. 26a).

The Government's argument in this regard is, in effect, two-fold: (1) Treas. Reg. § 1.1551-1 "supports the validity of the Section 1563 Regulations . . . ." (*Petitioner's Brief* at p. 33); and (2) Congress approved Treas. Reg. § 1.1551-1 through "statutory reenactment," or the doctrine of statutory incorporation of a prior administrative ruling.[6] The second prong of the Government's argument, i.e., statutory reenactment or incorporation, will be treated first.

It is crucial in this regard to note that Congress specifically limited its cross-reference in this particular segment of legislative history to the *statutory* language of IRC § 1551, and did not refer to the Treasury Regula-

6 The government also has asserted that Congress has approved Treas. Reg. § 1.1563-1(a)(3) because the Employer Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, §§ 1013(c) (1) and 1015, 88 Stat. 921, 925, incorporated § 1563(a) by reference in sections 404(a)(1)(c) and 414(b) of the Internal Revenue Code at a time when Treas. Reg. § 1.1563-1(a)(3) had already been published. *Petitioner's Brief* at p.33, fn. 7. see p.31, *infra*

tions thereunder, which had only been in existence for 22 months at the time Section 1563 was enacted. (Pet. App. 25a). While Congress may certainly incorporate by reference regulatory interpretation of a statute, it is not at all certain that such occurred with regard to Treas. Reg. § 1.1551-1. Incorporation by reference is dependent upon the intent of Congress, which appears in this instance to dictate that the regulations under IRC § 1551 were not to be so incorporated, contrary to the position of the Government. The use of the word "employed" in the legislative history clearly acts to incorporate the statutory language of IRC § 1551(b)(2); it does not indicate, however, that Treas. Reg. § 1.1551-1 was also to be incorporated, and indeed is not sufficient or positive proof that Congress had any knowledge of that regulation when enacting IRC § 1563. As the Court of Claims noted, "While it is clear that Congress intended the same statutory test to be applied . . ., there is no indication . . . that Congress was aware of or approved any regulation interpreting the control requirements for brother-sister corporations." (Pet. App. 24a-25a). Absent such proof and in view of the brief amount of time the regulations under IRC § 1551 had then been in effect, it is argued that Treas. Reg. § 1.1551-1 should not be deemed to have been incorporated into IRC § 1563(a)(2) by the legislative history's reference to IRC § 1551(b)(2), as the Government has assumed throughout. *See generally, United States v. Calamaro*, 354 U.S. 351 (1957); 1 MERTENS, LAW OF FEDERAL INCOME TAXATION § 3.23 (rev. 1974), and cases cited therein; 2 AM. JUR.2d, *Administrative Law* § 252-253 (1972), and cases cited therein. *See also, infra* p.31.

Consequently, the entire morass of inconsistencies and inferences (as described hereafter and by the Court of Claims) of the "I.R.C. § 1551 regulation" analogy argument made by the Government, and specifically Treas. Reg. § 1.1551-1(g)(4), Example 4 (upon which the Government places heavy reliance), may not be relevant to the issue at hand, or at best may be inconclusive as to

Congress' intent in enacting IRC § 1563(a)(2). Nothing could be more inconclusive than a situation where the regulations under IRC § 1551 are not applicable at all.

But even assuming that the Regulations under IRC § 1551 do apply, it is clear that they do not establish the interpretation which the Government is asserting Congress approved (the "first prong" of the Government's argument in this regard). For instance, nowhere under Treas. Reg. § 1.1551-1 do the words "singly or in combination" appear. If Congress did intend to incorporate Treas. Reg. § 1.1551-1, it is clear that the "singly or in combination" concept was not part of that incorporation. Any broader interpretation by Treas. Reg. § 1.1563-1 (a)(3) is thus out of step with the Congressional understanding of IRC § 1551. The Court of Claims held, accordingly, that (Pet. App. 26a):

> "Any implied congressional approval must necessarily be limited to the literal wording of the regulations and cannot be extended to a possible inference or interpretation. *Montana Power Co. v. United States*, 232 F.2d 541, 549 (3rd Cir.), *cert. denied*, 352 U.S. 843 (1956). In drafting Treas. Reg. § 1.1551-1, the Treasury did not add the words 'singly or in combination' to the statutory language as it did to the same language in Treas. Reg. § 1.1563-1(a)(3). Furthermore, the Treasury did not provide an explicit example such as Treas. Reg. § 1.1563-1(a)(3)(ii), Example (1), to show that persons owning stock in only one corporation can be counted in the 80-percent test."

While the Government asserts that Example 4 to Treas. Reg. § 1.1551-1(g)(4) supports their position, they omit discussion of the fact that several other examples are contained within the Regulation which can be said to support VFC's position. Indeed, the Court of Claims felt that even Example 4 could indicate a proposition contrary to that advocated by the Government (Pet. App. 27a):

"Another example, Treas. Reg. § 1.1551-1(g)(4), Example (4), on which defendant relies, may indicate a contrary proposition. In this example, individual A owns 55 percent of the stock of corporation X. Another 25 percent of the stock of X is owned in the aggregate by individuals B, C, D, and E. Individual A transfers property to corporation Y in exchange for 60 percent of the stock of Y, and B, C, and D acquire all of the remaining stock of Y. The example concludes, without providing any rationale, that the transfer is within the scope of section 1551(a)(3). Defendant argues that the example demonstrates that owning stock in both corporations is not a requirement of the 80-percent test. *However, the examples under paragraph (g) of Treas. Reg. § 1.1551-1 are intended as illustrations of the nature of the transfer required under that paragraph rather than as illustrations of the meaning and application of the term 'control' discussed in paragraph (e).* It has been suggested that the example merely illustrates that a transfer can be made by one, rather than all, of the individuals in control of the transferor corporation or that the controlling stockholders of the transferee corporation must come from the group of five or fewer stockholders of the transferor but need not include all of the members of that group. Bonovitz, *Brother-Sister Controlled Groups under Section 1563: The 80 Percent Ownership Test,* 28 TAX LAWYER 511, 524-28 (1975). These suggested constructions of the example would not conflict with our interpretation of section 1563(a)(2) and are just as likely to be the proper construction of an ambiguous example as that of defendant's."

Thus, Example 4, as isolated by the Government, was clearly intended to illustrate only the "transfer" requirements of Section 1551, requirements that are irrelevant to the control aspects essential to IRC § 1563.[7] If

7 The error by the Government on this point is made further clear

Treas. Reg. § 1.1551-1 is applicable at all to IRC § 1563(a)(2), then only the *control* aspects of that regulation are relevant.

Only one subsection of Treas. Reg. § 1.1551-1 can be found that deals explicitly with "control." Subsection (e) of Treas. Reg. § 1.1551-1 is entitled "Meaning and Application of the Term 'Control.'" (See Appendix, *infra.*). That subsection contains a definition of "control" similar to that of Treas. Reg. § 1.1563-1(a)(3), but again with the vital difference of containing *neither* the phrase "singly or in combination," or an example such as Treas. Reg. § 1.1563-1(a)(3)(ii), Example 1.[8] Clearly, therefore, if Congress was looking to Treas. Reg. § 1.1551-1 when enacting IRC § 1563, it did not authorize a regulation such as Treas. Reg. § 1.1563-1(a)(3).

It is further submitted, however, that there are examples of Treas. Reg. § 1.1551-1 outside of the "control" portion of that Regulation (which the Government did not discuss) that arguably deal with the question of control, (which it is clear the Government's "Example 4"

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when the statutory language of IRC § 1551(b)(2) is examined. The very language of IRC § 1551 contains six elements, some of which are *control* requirements and others of which are *transfer* requirements. For purposes of IRC § 1563, we are obviously interested only in the *control* portions of § 1551. (The Regulations under IRC § 1551 are themselves similarly organized into eight subsections designed and formulated to indicate the scope of the interpretation contained therein). The control elements provide that five or fewer persons must control a corporation and the transferor or transferors must, after the transfer, control the transferee corporation. These "two" groups are the same under IRC § 1551, and this single group must satisfy the control requirements with respect to the two corporations in question under IRC § 1551. Thus, the IRC § 1563(a)(2) group should also evidence common ownership under the 80-percent test.

8 Indeed, the only example given under Treas. Reg. § 1.1551-1(e) illustrates a situation where each stockholder owns stock in *each* corporation. Treas. Reg. § 1.1551-1(e)(3). Congress, if it reviewed such an example, no doubt thus understood and intended common ownership to apply to the 80-percent test of IRC § 1563(a)(2).

does not) and can be said to support VFC's position (or at least undermine the Government's position):

> "Example (2). On June 20, 1963, individual A, who owns all of the stock of corporation X, transfers property (other than money) to corporation Y, a corporation not actively engaged in business at the time of the acquisition of such property, in exchange for 60 percent of the voting stock of Y. During a later taxable year of Y, A acquires an additional 20 percent of such voting stock. After such acquisition A owns at least 80 percent of the voting stock of corporations X and Y. Accordingly, section 1551(a)(3) is applicable for the taxable year in which the later acquisition of stock occurred and for each taxable year thereafter in which the requisite control continues." Treas. Reg. § 1.1551-1(f)(2), Example 2.

Under this Example (2), then, the ownership test is not met until all persons counted own stock in both corporations. See also, Treas. Reg. § 1.1551-1(e)(3) and (f)(2), Example (3). Thus, based on these examples in Treas. Reg. § 1.1551-1, VFC's arguments are further strengthened.

Even if, however, one does not agree totally with this analysis of the examples of Treas. Reg. § 1.1551-1, it seems that the worst that can occur from VFC's standpoint is that such an analysis will be deemed inconclusive due to the apparent inconsistencies, as the Court of Claims ultimately found. The Tax Court's position on this particular point is as follows:

> "Both parties make reference to section 1.1551-1, Income Tax Regs., as being relevant to the disposition of the present case. Briefly, this regulation interprets the 80-percent test of section 1551(b)(2) to require that the five or fewer persons who own 80 percent of the transferee also be *one or more* of the five or fewer persons who own 80 percent of the transferor; however, there is no requirement that each of the persons who own 80 percent of the

transferor corporation must also own stock in the transferee corporation. While we express no opinion regarding this interpretation of section 1551(b)(2), we note that it is not a viable interpretation of section 1563(a)(2). If NOVA were deemed to be the transferor corporation, under such an interpretation NOVA and FAP would constitute a brother-sister controlled group. If FAP were deemed the transferor corporation they would not. Since respondent has pointed to no method of determining which corporation is to be regarded as the transferor, and we find none ourselves, we cannot engraft such an interpretation on section 1563(a)(2)." *Fairfax*, 65 T.C. at 806-807.

It is suggested that this same process of "engraftment" rejected by the Tax Court should also be rejected by this Court. For example, if VFC is deemed to be the transferor corporation, then VPC and VFC would constitute a brother-sister controlled group under IRC § 1551. However, if VPC is deemed the transferor, then (just as the Tax Court's example above illustrated) they are *not* a brother-sister controlled group. Section 1551 is thus clearly designed for a different factual and legal situation than is found under IRC § 1563, and when the attempt is made to apply its principles to the current factual problem, inconsistent results occur depending upon which corporation is chosen as the transferor in making the analogy. Such inconsistent results make the Government's arguments comparing IRC § 1551 with § 1563 of little use.

To summarize and cut across the fog in this area, it seems best to cite the argument well made by Bonovitz in an often-cited article:

"The regulations under section 1551, albeit ambiguous as to the question of common ownership, should be construed to require common ownership. The legislative history of section 1551(b)(2) unequivocally requires common ownership. Had the

draftsman of the regulations intended to deviate from the legislative mandate, he would surely have done so with greater clarity. Regulation Section 1.1551-1(e), dealing with the definition of control in section 1551(b)(2), implies a requirement of common ownership in each corporation by each shareholder; the only example in this regulation is one in which there is common stock ownership by the shareholders. The examples in section 1.1551-1(f) of the regulations, involving the taxable year of the allowance or disallowance in section 1551(a), are also consistent with this construction. The only inconsistency in the regulations is the example contained in section 1.1551(g), which deals with 'transfers' under section 1551(a). This one example, if construed to require less than common ownership, must, when balanced against the unambiguous legislative history of section 1551 and the more pertinent discussion in the regulations which points toward a common ownership requirement, *give way to the conclusion that the regulations under section 1551(b)(2) require that each of the shareholders owns stock in each corporation.*" Bonovitz, *Brother-Sister Controlled Groups Under Section 1563: The 80 Percent Ownership Test*, 28 *TAX LAW* 511 (1975).

4. In a manner similar to its arguments concerning the significance of Treas. Reg. § 1.1551-1, see p.24, *infra*, the Government has implied that the passage of the Employee Retirement Income Security Act of 1974, by incorporating by reference the controlled group definitions of IRC § 1563(a) in IRC § 414(b), shows that Congress implicitly approved of Treas. Reg. § 1.1563-1(a)(3). (*Petitioner's Brief* p. 33-34, fn. 7). This argument, however, has also been rejected by the Tax Court and the Court of Claims. In *Allen Oil Company, Inc.*, the Tax Court noted:

"ERISA was made law on September 2, 1974. . . .

> The regulation which respondent claims Congress thereby tacitly approved first appeared on April 25, 1972. . . . We think it questionable that, when Congress incorporated by reference its definition of controlled group as contained in section 1563(a), it also meant to incorporate and approve respondent's then recently promulgated regulatory interpretation. *The deference sometimes shown by courts for long standing regulations which have survived many congressional enactments can hardly be said to apply to regulations not even 1.5 years old at the relevant time." Allen Oil Company, Inc.*, T.C.M. 1979-88 (CCH) at 357, fn. 2 (citations omitted).

The Court of Claims similarly rejected the impact of ERISA's passage on the question herein. (Pet. App. 24a-25a).

The Tax Court's and Court of Claims' positions cited above are consistent with the generally accepted rules of statutory interpretation. The doctrine of statutory incorporation of a prior administrative ruling (even in cases of reenactment of a statute without substantial change) is generally found not to apply where the regulation has been in effect for only a short time before such reenactment, especially where there is no positive proof that Congress had some knowledge of the regulation. In *United States v. Calamaro*, 354 U.S. 351 (1957), statutory incorporation of a regulation by reenactment was not allowed where the regulation had been in effect for only *three* years and there was nothing to indicate that it was ever called to the attention of Congress. Since Treas. Reg. § 1.1563-1(a)(3) was in effect (as compared to published) for not even 1.5 years at the time ERISA was passed, and since no evidence is shown of Congress' knowledge of the regulation, statutory incorporation by reenactment is not properly invoked.[9] In any event, even reenactment of a statute

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9 See also, Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955); *Augustus v. Commissioner*, 118 F.2d 38 (6th Cir. 1941);

cannot shield a regulation where the regulation is found to improperly interpret the statute, as does Treas. Reg. § 1.1563-1(a)(3). *Janney v. Commissioner*, 108 F.2d 564 (3rd Cir. 1939), *aff'd sub. nom., Helvering v. Janney*, 311 U.S. 189 (1940).

Consequently, the Government's arguments for Treas. Reg. § 1.1563-1(a)(3) cannot be upheld on this basis. As *Mertens* notes:

> "In complex income tax law it is absurd to indulge in the fiction that the full import of Treasury Regulations and administrative practice is known to the members of Congress. Statutes have been frequently re-enacted without any consideration given to many of the specific sections of the act, the re-enactment being concerned primarily with a revision of a limited number of sections to close loopholes and the addition of a few new sections. As the Supreme Court stated in the case of *Helvering v. Halcock* [309 U.S. 106 (1940)]: '. . . we walk on quicksand when we try to find in the absence of corrective legislation a controlling legal principle.'" 1 *MERTENS, LAW OF FEDERAL INCOME TAXATION* § 3.24 (rev. 1974) at p. 57.

5. Finally, the unjustified and unreasonable expansion by the Regulations of the intended impact of IRC § 1563(a)(2) was seen clearly by the Tax Court in rebutting the Government's argument to the effect that Treas. Reg. § 1.1563-1(a)(3) acts to "fill a loophole" left by Congress in the statute:

"Respondent, however, urges that we sanction

Commissioner v. F.H.E. Oil Co., 102 F.2d 596 (5th Cir. 1939), *aff'd* 308 U.S. 104 (1939); *Eastman Kodak Co. v. United States*, 48 F. Supp. 357 (Ct.CL. 1943); *Hugoton Production Co. v. United States*, 349 F.2d 418 (Ct.Cl. 1965); *Casey v. Sterling Cider Co.*, 294 F. 426 (1st Cir. 1923); *Commissioner v. Sun Pipe Line Co.*, 126 F.2d 888 (3rd Cir. 1942); 1 *MERTENS, LAW OF FEDERAL INCOME TAXATION* § 3.23 (rev. 1974), and cases cited therein; 2 AM. JUR.2d, *Administrative Law* § 252-253 (1972), and cases cited therein.

his statutory interpretation as evidenced by the aforenoted regulation to preclude an easy path on which to bypass controlled group status in the brother-sister context. We do not find it a realistic belief that an individual would dispose of his entire interest in a corporation to enable that corporation and its remaining shareholders to reap the financial benefits of a full surtax exemption. To the contrary, respondent's interpretation permits him to snare with the definitional web woven by the words 'singly or in combination' corporations that Congress never intended to bring within the ambit of the multicorporate provisions." *Fairfax*, 65 T.C. at 805.

In a footnote to the above quote, the Tax Court supplied the following example of how the Government's position adds to the statute what was not intended because of its tendency to unfairly "surprise" minority shareholders with the loss of the surtax exemption because of actions taken possibly unbeknown to them by a majority shareholder over whom they have no control:

"A prime example is a variant of the factual situation involved herein. Individual A owns 55 percent of corporation X and individual B owns 45 percent thereof. If A were independently to enter into a second business in corporate form the corporations would be component members of a controlled group. We cannot believe that Congress intended to surprise B with such a result. We recognize that had A owned 80 percent of corporation X and B 20 percent thereof, the corporations would constitute a controlled group. However in the latter instance, B's unfortunate surprise would be necessitated by both the mechanical application of the stock ownership tests and the respective functions of the 80 percent and 50 percent tests discussed *infra*." *Fairfax*, 65 T.C. at 805, fn. 5.

It is this inequitable surprise that is bestowed

upon minority shareholders under Treas. Reg. § 1.1563-1 (a)(3) that vitiates and ultimately destroys what the Government has described as "the most telling point against the statutory interpretation . . . ." by the Court of Claims, Tax Court, and Fifth Circuit, i.e., that VFC and VPC "would have constituted a brother-sister controlled group if Richard Crain owned but a single share of Vogel Popcorn." (*Petitioner's Brief* at p. 10, 24-26). Congress *must* have intended the statute turn on ownership in both corporations (contrary to the Government's assertions), even if such ownership consists of only one share, since an increase in taxes should equitably only be suffered in this case because of an affirmative action taken by the taxpayer himself, rather than by actions of another stockholder completely outside his control. As the Court of Claims noted (Pet. App. 32a-33a):

> "Defendant contends that had Congress intended to require common ownership as part of the 80-percent test, it would have provided for some minimum and meaningful level thereof and would not have left it to turn upon the happenstance of a symbolic but factually meaningless ownership of a single share. Defendant's argument may seem valid in the abstract but it has no merit when the predictable actions of real taxpayers are considered. It might well be appropriate not to consider the ownership of a token amount of stock if taxes could be *avoided* by such ownership. Here the ownership of a token amount of stock would *increase* taxes, and Richard Crain would be most ill advised to acquire one share of stock in Vogel Popcorn and so cause the 80-percent test to be satisfied. Presumably, Mr. Crain is aware of the tax laws and would only acquire stock in Vogel Popcorn if he wished to make an investment of sufficient magnitude to compensate for the loss of a surtax exemption." (Emphasis in text).

Richard Crain in this instance must believe that the "surprise" of losing the surtax exemption because a fellow shareholder happens to own another corporation completely separate from Mr. Crain is a result not intended by Congress. When viewed from this standpoint, it becomes even more clear that the Government's proposed definition of a brother-sister control group is a totally unwarranted extension of the statutory language of IRC § 1563(a)(2), and is therefore an unrealistic and unreasonable interpretation of the statute. As such, Treas. Reg. § 1.1563-1(a)(3) must be found invalid.

Furthermore, the common ownership requirement in the 80-percent test is hardly one of "no economic significance" turning upon "minute distinctions [that] make no economic difference." (*Petitioner's Brief* at p. 25). Stock ownership, even one-share stock ownership, carries with it significant rights, opportunities, and disabilities:

> "The shareholder may vote to elect and remove directors, adopt, amend and repeal bylaws, adopt resolutions, affect extraordinary corporate matters, and see corporate books and records. See Henn, Law of Corporation §§ 188, 189, 192, 193, 194, 195 & 199 (2d ed. 1970). He also has standing to bring suit against an officer or director of the corporation who breaches his fiduciary duties to the entity, or under the Securities Act of 1934. *See id.* at § 200; *Rekant v. Desser*, 425 F.2d 872, 876 (5th Cir. 1970)." *Delta Metalforming*, 632 F.2d at 450.

Consequently, Congress by requiring the principle of common ownership in the 80-percent test has not been criticized fairly by the Government through their objections that such a requirement may be hardly meaningful, trifling, or turning upon an economically meaningless fact in some instances.

Nor does the application of the principle of common ownership subvert Congress's intent in passing the

controlled group definitions of IRC § 1563(a), as the Government argues. (See *Petitioner's Brief* at p. 25; fn 4, p. 25-26). The original purpose of the surtax exemption, enacted in 1950, was to reduce the tax burden on small businesses. *See* Revenue Act of 1950, ch. 994, § 15(b), 64 Stat. 915 (repealed 1978) (formerly codified at IRC § 11(c).) *See also* H.R. REP. NO. 2319, 81st Cong., 2d Sess. 26-27 (1950); *Hearings on the President's 1963 Tax Message Before the House Comm. on Ways and Means,* 88th Cong., 1st Sess., pt. 1 at 5 (1963). Small businesses were to be stimulated (not penalized as was VFC under Treas. Reg. § 1.1563-1(a)(3)) by the lowering, in effect, of their effective tax rate on their surtax exemption income. Congress enacted and revised IRC § 1563(a)(2), on the other hand, in response to the specific problem of large companies subdividing into many small corporations so as to obtain multiple exemptions and the resultant lower effective tax rate. *See* Revenue Act of 1964, Pub. L. No. 88-272, § 235(a), 78 Stat. 116. The problem Congress faced, and solved, in enacting § 1563(a)(2) was to design a statutory scheme, therefore, that identified the "small" corporations that were actually components of much larger business units while still giving the benefit of the surtax exemption to those it was originally intended to benefit, i.e., the "bona fide" small business. This design can only be carried out if the principle of common ownership is applicable to the 80-percent test, since the only means of discovering the link between those "small" corporations which are part of that "large economic entity" is by the financial interest the large entity has in the small.

In order to measure common ownership in this manner, then, the 80-percent test could only have been meant by Congress to take into account only the stockholdings of persons (or entities) who own an interest in each corporation in the alleged controlled group. Indeed, only with this type of test is there symmetry between the brother-sister controlled group tests and

the test determining parent-subsidiary controlled groups under IRC § 1563(a)(1) (Pet. App. 29a-30a):

> "Furthermore, section 1563(a)(1) provides persuasive evidence that Congress would require a significantly greater overlap of stockholdings than 50 percent before it would treat two or more corporations as one entity. Section 1563(a)(1) defines a 'parent-subsidiary controlled group' as existing where a parent corporation owns stock representing 80 percent of the value or voting power of one or more subsidiary corporations either directly or indirectly through a subsidiary. It seems highly unlikely that Congress would require a lesser identity of ownership between brother-sister corporations owned by up to five persons than between a more centralized and more easily controlled parent-subsidiary group."

It seems that what the Government is really objecting to is the power of Congress to set percentage requirements in the area of tax law. However, it is obvious that the Government does not have the power or right to make such an objection, as it is the Congress (and not the Treasury) that is empowered to write the numerical requirements necessarily a part of tax law. The Fifth Circuit aptly stated this fact of tax law, which the Government desires to ignore through Treas. Reg. § 1.1563-1(a)(3):

> "Particularly in the area of federal taxation, we should not ignore percentage requirements obviously and specifically fixed by Congress. While the result may seem 'arbitrary' — ownership of a single share may be critical — 79% will not suffice while 80% will — revenue laws necessarily encompass maximums, minimums, cutoffs and the like. In that sense all specific standards expressed in numbers or percentages are arbitrary. One side of the line is IN, the other side OUT." *Delta Metalforming*, 632 F.2d at 450.

In this matter, it is clear that Treas. Reg. § 1.1563-1(a)(3) is "OUT" as an attempt by Treasury to rewrite the application of the percentage requirements set by Congress.

B. The application of the principle of common ownership to the 80-percent test is compelled by the statutory language of Section 1563(a)(2).

In support of the statutory construction by which it counts Mr. Crain's stock, the Government has advanced the theory that the "natural reading" of the statute results in the conclusion that "it is only with respect to the 50% test that the statute imposes the requirement that some of the five or fewer persons own stock in each corporation." *(Petitioner's Brief* at p. 20). The Government asserts, therefore, that the fundamental error of the Court of Claims, Tax Court, and Fifth Circuit was to ignore the fact that the phrase "each such person" is "found only in sub-paragraph (B) with respect to the 50% test." (*Petitioner's Brief* at p. 9).

The major problem with the "natural reading" theory of the Government is that it ignores well-established and commonly used guidelines of English usage and grammer. *See, e.g., Delta Metalforming,* 632 F.2d at 446 (dictionary definitions of the statutory terminology underscore and compel "a reading requiring that for the 80% test each shareholder must own stock in each of the corporations."). A proper grammatical analysis of the statute results in a conclusion that the principle of common ownership (but not, as explained more fully hereafter, *identical* ownership) applies to the 80-percent test just as it applies to the 50-percent test. To rebut the Government's arguments concerning statutory construction, VFC can do no better than to reiterate the Tax Court's majority opinion in *Fairfax,* upon which the Court of Claims placed great weight. The Tax Court dismissed the Government's arguments as follows:

"The key words of the statute relevant to an analysis of the issue are:

'if 5 or fewer persons . . . own . . .

(A) at least 80 percent . . . of each corporation, and

(B) more than 50 percent . . . of each corporation, taking into account the stock ownership of *each such person* only to the extent such stock ownership is identical with respect to each such corporation'.

"Since the 'five or fewer persons' is the conjunctive subject of both the 80-percent test and the 50-percent test, it cannot be gainsaid that both tests must be satisfied by the same ownership group. However, to gain entrance into the ownership group for purposes of the 50-percent test one must possess stock in each corporation involved since an absence of such stock ownership produces an identical stock ownership of zero or, put another way, no stock ownership at all. If ownership of stock in each corporation involved is a precondition to membership in the ownership group for purposes of the 50-percent test, and the ownership groups for the 50-percent test and 80-percent test are one and the same, *it follows in our mind that one must own stock in each corporation before his stock can be taken into account for purposes of the 80-percent test.*

"Furthermore, the language of the 50-percent test comports with this analysis. The words 'each such person' appearing therein refer to the 'five or fewer persons' constituting the ownership group for purposes of both the 80-percent and the 50-percent tests. The import of such usage is that each person — and not just some of the persons — counted for purposes of the 80-percent test must be also counted for purposes of the 50-percent test. To interpret the

statutory language as respondent has done in his regulation is plainly inconsistent with the thrust of the statutory language. Hence, we hold that for a person's stock ownership to be taken into account for purposes of the 80-percent test that person must own stock in each member of the brother-sister controlled group. Since respondent's regulations advance a contrary interpretation, we hold them, to that extent, invalid." *Fairfax*, 65 T.C. 798, 803 (1976). (Emphasis added).

Accordingly, the application of the principle of common ownership to the 80-percent test is compelled by the rules of English usage and grammar. The use of a common tool of statutory construction, the "last antecedent doctrine," confirms this conclusion, as it obtains the same result. The Court of Claims illustrated this point as follows (Pet. App. 11a-12):

"Defendant further relies upon the 'last antecedent' doctrine to dispute that the phrase 'each such person' in the 50-percent test refers to the '5 or fewer persons' who are the subject of both tests. This doctrine requires that qualifying words, phrases, and clauses in a statute are to be applied to the words or phrase immediately preceding and are not to be construed as extending to and including others more remote. *Azure v. Morton*, 514 F.2d 897, 900 (9th Cir. 1975); *Quindlen v. Prudential Ins. Co. of America*, 482 F.2d 876, 878 (5th Cir. 1973). Defendant misunderstands the function of this doctrine, which, for example, would establish (in the absence of clarifying indentation) that the qualifying clause 'taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation only applies to the immediately preceding 50-percent test and not to the more remote 80-percent test. The phrase '5 or fewer persons' is the most immediately preceding refer-

> ence to 'persons' prior to the phrase 'each such person.' As such, both common English usage and the 'last antecedent' doctrine support the Tax Court's interpretation."

See also, 2A Sutherland, *Statutes and Statutory Construction* § 47.33 (4th ed. 1973); 82 C.J.S. *Statutes* § 334 (1981).

Thus, it can be seen that the mere location of the term "each such person," which is characterized by the Government as "The most striking characteristic of the statutory language and structure . . . ." in favor of its analysis (*Petitioner's Brief* at p. 20), does not afford the Government the comfort it has drawn from that factor. Rather, under the last antecedent doctrine the correct reading of the statute plainly requires that the 80-percent stock ownership be drawn from "each such person" of the group of "5 or fewer persons." Since, for purposes of the 50-percent test, that group of "5 or fewer persons" must own stock in each corporation to be counted, it is only logical that the principle of common ownership also then apply to the 80-percent test. *Fairfax,* 65 T.C. at 803; *Delta Metalforming,* 632 F.2d at 446; *T.L. Hunt, Inc. v. Commissioner,* 562 F.2d 532, 536 (8th Cir. 1977) (Webster, J., dissenting).

As the Government concedes, the Tax Court, Fifth Circuit, and Court of Claims have not suggested by this analysis, and VFC is not suggesting, that the "identical interest" portion of the 50-percent test is somehow drawn into the 80-percent test. The two tests remain completely separate components of the statute, one testing *identical* overlapping interests, and the other testing overlapping *financial* interests. Therefore, the 80-percent test does not "necessarily swallow up and displace the 50 percent test" under the Court of Claims decision, as implied by the Government. (*Petitioner's Brief* at p. 23).

The Government further objects that "the statutory interpretation by the Court of Claims contains no

limiting principle that makes any particular portion of subparagraph (B) any more or less appropriate for importation into subparagraph (A)." (*Petitioner's Brief* at p. 23). However, it is argued that the analysis by the Court of Claims *is* self-limiting by very reason of the last antecedent doctrine and other grammatical rules earlier discussed. The analysis by the Court of Claims is limited to the use of "intrinsic aids" commonly found in statutory interpretation to determine the qualifications of the group to whom the 80-percent test should apply. This process cannot and should not be extended further. Once it is established via these aids that the 80-percent test requires common ownership, the two tests then work separately and independently to fulfill their purposes, as Congress intended (and as discussed further herein).

When the language of IRC § 1563(a)(2) is thus correctly analyzed under well-established and commonly used guidelines of English usage and grammar, the statutory construction by the Court of Claims, Tax Court, and Fifth Circuit is clearly correct in requiring the application of common ownership to the 80-percent test. It can only be assumed that Congress intended to follow the rules of good grammar and English usage. Therefore, the result obtained from the application of such rules, i.e., the requirement of common ownership, must be the result intended by Congress, as the previous discussion of the legislative history and purpose of IRC § 1563(a)(2) has shown.

C. The deference usually given a Treasury Regulation is not appropriate in this case. The Commissioner does not have the authority to add to Section 1563(a)(2) by regulation what he thinks Congress has overlooked.

VFC well understands that in most instances, Treasury Regulations must be sustained unless shown to be unreasonable and plainly inconsistent with the revenue statutes. *Commissioner v. South Texas Lumber*

Co., 333 U.S. 496 (1948). This normal policy of "deference," however, is not appropriate in this case, as Treas. Reg. § 1.1563-1(a)(3) has been shown herein and by the Tax Court, Fifth Circuit, and Court of Claims to be unreasonable, inconsistent with the intent of Congress and purpose of the statute, and outside the authority of the Commissioner. *United States v. Cartwright*, 411 U.S. 546 (1973); *United States v. Calamaro*, 354 U.S. 351 (1957).

As *Mertens* notes, "The Treasury may not make an arbitrary or unreasonable Regulation, nor can it restrict or enlarge the scope of a statute, supply a supposed omission, create an exemption, limit any rights thereunder, or nullify a prior judicial construction of the statute." 1 *MERTENS, THE LAW OF FEDERAL INCOME TAXATION* § 3.21 (rev. ed. 1974). Treas. Reg. § 1.1563-1(a)(3) has been shown: (1) to be unreasonable in view of congressional intent and statutory purpose; (2) to enlarge the scope of IRC § 1563 by the "definitional web" of the words "singly or in combination"; (3) to be an attempt to supply a supposed omission to IRC 1563; and (4) to limit the rights of VFC and many other taxpayers to utilize the surtax exemption specifically given to them as small businesses by Congress. In view of this situation, the Government should not be allowed to hide behind the respect usually granted by this Court to the Commissioner's regulations, as Treas. Reg. § 1.1563-1(a)(3) has not earned that privilege.[10]

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10 Treas. Reg. § 1.1563-1(a)(3) has received almost universal criticism by commentators, starting from the date of the initial promulgation of the regulation. As noted by the Fifth Circuit, "the overwhelming opposition has special significance." *Delta Metalforming*, 632 F.2d at 449. See Libin and Abramowitz, *"Multiple Corporations: A Surprising Interpretation of Sec. 1563(a)(2) in* Temporary Regulations," 3 *TAX ADVISOR* 326 (1971); Thomas, *"Brother-Sister Multiple Corporation — The Tax Reform Act of 1969 Reformed by Regulation,"* 28 *TAX L. REV.* 65 (1972); Kringel, *"Multiple Corporation Proposed Regulations Raise More Questions Than They Answer,"* 36 *J. TAX.* 358 (1972); Pearlman, *"Recasting the Multiple Corporate Group after the Multiple*

As this Court has noted, the principle of deference to the administration efforts of the Commissioner is only designed so as "to set the framework for judicial analysis: it does not displace it." *United States v. Cartwright*, 411 U.S. 546 at 550 (1973). It does not follow that simply "because [the Commissioner] has a choice of alternatives, his choice should be sustained where the alternative chosen is unrealistic. In such a situation the regulations embodying that choice should be held to be unreasonable." *Id.* at 557. As stated by this Court in *Manhattan General Equipment Co. v. Commissioner*, 297 U.S. 129, 134 (1936):

> "The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law, for no such power can be delegated by Congress, but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity. *Lynch v. Tilden*

Surtax Exemption Ends," 41 *J. TAX.* 194, 199 (1974); Bonovitz, *"Brother-Sister Controlled Groups Under Section 1563: The 80 Percent Ownership Test,"* 28 *TAX LAW* 511 (1975); Student Note, 1976 *BRIGHAM YOUNG LAW REV.* 100; Weisman, *"Brother-Sister Controlled Corporations: On and Off the Road to the Supreme Court With an Edsel,* 56 *TAXES* 475 (Aug. 1978); Student Comment, *"Brother-Sister Controlled Groups: Tax Court Stands Firm in the Face of Reversal,"* 13 *CREIGHTON L. REV.* 543 (1979); Student Comment, *"The Brother-Sister Controlled Group Under IRC* § 1563(a)(2)," 67 *VA. L. REV.* 751 (1981) Hoffman, *"The 80 Percent Ownership Test For Brother-Sister Controlled Groups: The Controversy Continues,"* 58 *TAXES* 329 (1980); Student Note, *"Brother-Sister Controlled Groups: The Basic Eighty Percent Stock Ownership Test as Control,"* 58 *TEXAS L. REV.* 1161 (1980); cf. White, *"The Tax Reform Act of 1969: Demise of Multiple Surtax Exceptions — When Too much of a Good Thing Proved its Undoing,"* 16 *WAYNE L. REV.* 1353 (1974).

Consequently, a substantial body of authorities exist to support a finding that Treas. Reg. § 1.1563-1(a)(3) is invalid.

Produce Co., 265 U.S. 315, 320-322 (1924); *Miller v. United States*, 294 U.S. 435, 439, 440 (1935) and cases cited."

The situation in this case requires a similar holding:

"It is questionable, however, whether such discretion should be given to the Treasury's interpretation of the statute in this instance for several reasons. First, the statute at issue is definitional and should not be applied beyond a narrow application without congressional approval. That is, the underlying effect of Section 1563 was to replace a subjective test with a mechanical test. The application of the Treasury's interpretation to the statute substantially broadens its impact. Because the statute is not only interpretative but also definitional it should be strictly construed. Second, as previously discussed, there are fundamental inconsistencies between the Treasury's interpretation of the language of the statute and Congress's intent. Third, the tax policy and functions underlying the purpose of the statute constitute 'weighty reasons' sufficient for the Court in this case not to defer so readily to the administrative interpretation of the Treasury." Weisman, *Brother-Sister Controlled Corporations: On and Off the Road to the Supreme Court With an Edsel*, 56 *TAXES* 475 at 482 (1978).

Furthermore, Treas. Reg. § 1.1563-1(a)(3) is clearly an example of an "interpretative" regulation drafted under the auspices of IRC § 7805, rather than a "legislative" regulation written in response to a specific delegation of authority by Congress. As such, the Regulation should not be considered as having the force and effect of law; rather, this Court is free to analyze, construe, and apply the statutory provisions of IRC § 1563 independent of such Regulation. *United States v. Cartwright*, 411 U.S. 546 (1973); 2 AM. JUR.2d, *Administrative Law* § 251 (1962). Where, as shown

earlier herein, the Regulation is found to be an erroneous administrative interpretation of a nonambiguous statute, and where, as here, the Regulation unilaterally and without authority expands the scope of the statute beyond that intended by Congress, thereby limiting the right of taxpayers to utilize the surtax exemption privilege granted by Congress, the Regulation should be found inconsistent with the law and inappropriate to accomplish the purposes of Congress. *See*, 1 *MERTENS LAW OF FEDERAL INCOME TAXATION* § 3.21 (rev. 1974).

As *Mertens* notes, "In determining the effect of Treasury Regulations it is important to keep in mind that the Treasury's interest is in revenue and naturally its Regulations are favorable to its maintenance rather than unbiased." *Id.* § 3.21 at 44-45. This bias of the Treasury in conflict with statutory provisions is clearly evident in Treas. Reg. § 1.1563-1(a)(3). By adding the words "singly or in combination," the Commissioner has deliberately and liberally expanded the intended impact of IRC § 1563. The Commissioner, however, has no more power to add to the Code what he thinks Congress overlooked, even to protect the revenue, than he has to supply what Congress has deliberately omitted. *United States v. Calamaro*, 354 U.S. 351, 359 (1957) ("we cannot but regard this Treasury Regulation as no more than an attempted addition to the statute of something which is not there."); *Arkansas-Oklahoma Gas Co. v. Commissioner*, 201 F.2d 98 (8th Cir. 1953). The Government may believe and argue that statutory verbal difficulties should be resolved in the interest of improving the health of the fisc, and thus assert that Treas. Reg. § 1.1563-1(a)(3) should be upheld. However, such an assertion is not a valid argument for promulgating overly broad regulations. *United States v. Calamaro*, 354 U.S. 351, 357 (1957) ("Neither we nor the Commissioner may rewrite the statute simply because we may feel that the scheme it creates could be improved upon."); *Estate of Willett*

v. Commissioner, 365 F.2d 760, 769 (5th Cir. 1966). This Court has held that simply because the Commissioner feels he can improve the phraseology of a statute or can improve the revenue collecting position, this is no justification to ignore statutory language or the intent of Congress. *United States v. Calamaro*, 354 U.S. 351, 359 (1957); *Morrill v. Jones*, 106 U.S. 466 (1883).

CONCLUSION

From the foregoing, it is clear that the language and intent of IRC § 1563(a) compels the conclusion that Treas. Reg. § 1.1563-1(a)(3) is invalid as a matter of law, and that IRC § 1563(a)(2) requires the principle of common ownership be applied to the 80-percent test. Analysis of the legislative history and the underlying purpose for the enactment of IRC § 1563(a) does not support the Government's position. By the addition of the phrase "singly or in combination" to the statutory language otherwise traced by Treas. Reg. § 1.1563-1(a)(3), Treasury has expanded the scope of IRC § 1563(a)(2) to ensnare corporations Congress never intended to trap. As such, the regulation is an unreasonable and overreaching interpretation of IRC § 1563(a)(2) and should not be upheld.

Consequently, this Court is respectfully requested to follow the clearly defined trail already blazed and marked by the Court of Claims, Fifth Circuit, and Tax Court, hold that VFC is not a member of a "brother-sister controlled group" within the meaning and intent

of IRC § 1563(a)(2), and allow VFC's claims for refunds by affirming the judgment of the Court of Claims.

Respectfully submitted,

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APPENDIX

STATUTES INVOLVED:

Internal Revenue Code of 1954 (26 U.S.C.):

I.R.C. § 11(d) [as amended by Revenue Act of 1964, Pub. L. No. 88-272, Section 121, 78 Stat. 25; and Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(b)(2)(B), 83 Stat. 602]:

> (d) *Surtax Exemption.* — For purposes of this subtitle, the surtax exemption for any taxable year is $25,000, except that, with respect to a corporation to which section 1561 or 1564 (relating to surtax exemptions in case of certain controlled corporations) applies for the taxable year, the surtax exemption for the taxable year is the amount determined under such section."

(Note: effective for taxable years ending in 1975, IRC § 11(d) was amended to provide a surtax exemption of $50,000.00. *See* Tax Reduction Act of 1975, Pub. L. No. 94-12, Section 303(b), 89 Stat. 26.).

* * * * *

IRC § 1561(a) [as added by Revenue Act of 1964, Pub. L. No. 88-272, Section 235(a), 78 Stat. 116; applicable for taxable years ending before January 1, 1975]:

> SURTAX EXEMPTIONS IN CASE OF CERTAIN CONTROLLED CORPORATIONS.
>
> (a) *General Rule.* — If a corporation is a component member of a controlled group of corporations on December 31, then for purposes of this subtitle the surtax exemption of such corporation for the taxable year which includes such December 31 shall be an amount equal to —
>
> (1) $25,000 divided by the number of corporations which are component members of such group on such December 31, or

(2) if all such component members consent (at such time and in such manner as the Secretary or his delegate shall by regulations prescribe) to an apportionment plan, such portion of $25,000 as is apportioned to such member in accordance with such plan.

The sum of the amounts apportioned under paragraph (2) among the component members of any controlled group shall not exceed $25,000.

* * * * *

IRC § 1561(a) [as added by Revenue Act of 1964, Pub. L. No. 88-272, Section 235(a), 78 Stat. 116, and amended by Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(a)(1), 83 Stat. 599, applicable for taxable years ending in 1975]:

LIMITATIONS ON CERTAIN MULTIPLE TAX BENEFITS IN THE CASE OF CERTAIN CONTROLLED CORPORATIONS.

(a) *General Rule.* — The component members of a controlled group of corporations on a December 31 shall, for their taxable years which include such December 31, be limited for purposes of this subtitle to—

(1) one $50,000 surtax exemption under section 11(d),

(2) one $100,000 amount for purposes of computing the accumulated earnings credit under section 535(c)(2) and (3), and

(3) one $25,000 amount for purposes of computing the limitation on the small business deduction of life insurance companies under sections 804(a)(4) and 809(d)(10).

The amount specified in paragraph (1) shall be

divided equally among the component members of such group on such December 31 unless all of such component members consent (at such time and in such manner as the Secretary or his delegate shall by regulations prescribe) to an apportionment plan providing for an unequal allocation of such amount. The amounts specified in paragraphs (2) and (3) shall be divided equally among the component members of such group on such December 31 unless the Secretary or his delegate prescribes regulations permitting an unequal allocation of such amounts.

* * * * *

IRC § 1562 [as added by Revenue Act of 1964, Pub. L. No. 88-272, Section 235(a), 78 Stat. 117. Repealed for taxable years beginning after December 31, 1974 by Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(a)(2), 83 Stat. 600]:

PRIVILEGE OF GROUPS TO ELECT MULTIPLE SURTAX EXEMPTIONS.

(a) *Election of Multiple Surtax Exemptions.*—

(1) *In general.* — A controlled group of corporations shall (subject to the provisions of this section) have the privilege of electing to have each of its component members make its returns without regard to section 1561. Such election shall be made with respect to a specified December 31 and shall be valid only if—

(A) each corporation which is a component member of such group on such December 31, and

(B) each other corporation which is a component member of such group on any succeeding December 31 before the day on which the election is filed,

consents to such election.

(2) *Years for which effective.* — An election by a controlled group of corporations under paragraph (1) shall be effective with respect to the taxable year of each component member of such group which includes the specified December 31, and each taxable year of each corporation which is a component member of such group (or a successor group) on a succeeding December 31 included within such taxable year, unless the election is terminated under subsection (c).

(3) *Effect of election.* — If an election by a controlled group of corporations under paragraph (1) is effective with respect to any taxable year of a corporation—

(A) section 1561 shall not apply to such corporation for such taxable year, but

(B) the additional tax imposed by subsection (b) shall apply to such corporation for such taxable year.

(b) *Additional Tax Imposed.*—

(1) [as amended by Sec. 401(b)(2)(A), Tax Reform Act of 1969, *supra*] *General rule.* — If an election under subsection (a)(1) by a controlled group of corporations is effective with respect to the taxable year of a corporation, there is hereby imposed for such taxable year on the taxable income of such corporation a tax equal to 6 percent of so much of such corporation's taxable income for such taxable year as does not exceed the amount of such corporation's surtax exemption for such taxable year. This paragraph shall not apply to the taxable year of a corporation if—

(A) such corporation is the only component member of such controlled group on the December 31 included in such corportation's

taxable year which has taxable income for a taxable year including such December 31, or

(B) such corporation's surtax exemption is disallowed for such taxable year under any provisions of this subtitle. . . ."

* * * * *

IRC § 1563(a) (2) [as added by Revenue Act of 1964, Pub. L. No. 88-272, Section 235(a), 78 Stat. 120. Effective for tax years ending before January 1, 1971 (current version at IRC § 1563(a)(2)]:

"(a)(2) Brother-Sister Controlled Group — Two or more corporations if stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each of the corporations is owned (within the meaning of subsection (d)(2)) by one person who is an individual, estate, or trust."

* * * * *

IRC § 1563(a)(2) [as added by Revenue Act of 1964, Pub. L. No. 88-272, Section 235(a), 78 Stat. 120, and amended by Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(c), 83 Stat. 602]:

DEFINITIONS AND SPECIAL RULES.

(a) *Controlled Group of Corporations.* — For purposes of this part, the term "controlled group of corporations" means any group of—

. . . . .

(2) [as amended by § 401(c), Tax Reform Act of 1969, *supra*] *Brother-Sister controlled group.* — Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing—

(A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and

(B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.

* * * * *

IRC § 1564(a) [as added by Tax Reform Act of 1969, Pub. L. No. 91-172, Section 401(b)(1), 83 Stat. 600]:

TRANSITIONAL RULES IN THE CASE OF CERTAIN CONTROLLED CORPORATIONS.

(a) LIMITATION OF ADDITIONAL BENEFITS.—

(1) *In general.* — With respect to any December 31 after 1969 and before 1975, the amount of—

(A) each additional $25,000 surtax exemption under section 1562 in excess of the first such exemption,

(B) each additional $100,000 amount under section 535(c)(2) and (3) in excess of the first such amount, and

(C) each additional $25,000 limitation on the small business deduction of life insurance companies under sections 804(a)(3) and 809(d)(10) in excess of the first such limitation,

otherwise allowed to the component members of a controlled group of corporations for their

taxable years which include such December 31 shall be reduced to the amount set forth in the following schedule:

Taxable years including—	Surtax exemption	Amount under sec. 535(c) (2) and (3)	Small business deduction limitation
Dec. 31, 1970	$20,833	$83,333	$20,833
Dec. 31, 1971	16,667	66,667	16,667
Dec. 31, 1972	12,500	50,000	12,500
Dec. 31, 1973	8,333	33,333	8,333
Dec. 31, 1974	4,167	16,667	4,167

(2) *Election.* — With respect to any December 31 after 1969 and before 1975, the component members of a controlled group of corporations shall elect (at such time and in such manner as the Secretary shall by regulations prescribe) which component member of such group shall be allowed for its taxable year which includes such December 31 the surtax exemption, the amount under section 535(c)(2) and (3), or the small business deduction limitation which is not reduced under paragraph (1)."

* * * * *

REGULATIONS INVOLVED:

Treas. Reg. § 1.1551-1(e)(1) and (3) (1967) (26 C.F.R.):

(e) *Meaning and application of the term "control"* — (1) *In general.* For purposes of this section, the term "control" means—

(i) With respect to a transferee corporation described in paragraph (a)(1) or (2) of this section, the ownership by the transferor corporation, its shareholders, or both, of stock possessing either *(a)* at least 80 percent of the total combined voting power of all classes of stock entitled to vote, or *(b)* at least 80 percent of the total value of shares of all classes of stock.

(ii) With respect to each corporation described in paragraph (a)(3) of this section, the ownership by five or fewer individuals of stock possessing (*a*) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and (*b*) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such individual only to the extent such stock ownership is identical with respect to each such corporation.

* * * * *

(3) *Example.* This paragraph may be illustrated by the following example:

Example. On January 1, 1964, individual A, who owns 50 percent of the voting stock of corporation X, and individual B, who owns 30 percent of such voting stock, transfer property (other than money) to corporation Y (newly created for the purpose of acquiring such property) in exchange for all of Y's voting stock. After the transfer, A and B own the voting stock of corporations X and Y in the following proportions:

Individual	Corporation X	Corporation Y	Identical Ownership
A	50	30	30
B	30	50	30
Total	80	80	60

The transfer of property by A and B to corporation Y is a transfer described in paragraph (a)(3) of this section since (i) A and B own at least 80 percent of the voting stock of corporations X and Y, and (ii) taking into account each such individual's stock ownership only to the extent such ownership is

identical with respect to each such corporation, A and B own more than 50 percent of the voting stock of corporations X and Y.

* * * * *

Treas. Reg. § 1.1563-1(a)(1) and (3) (1965) (26 C.F.R.):

"Definition of controlled group of corporations and component members.

(a) Controlled group of corporations — (1) *In general.* For purposes of sections 1561 through 1563 and the regulations thereunder, the term 'controlled group of corporations' means any group of corporations which is either a 'parent-subsidiary controlled group' (as defined in subparagraph (2) of this paragraph), a 'brother-sister controlled group' (as defined in subparagraph (3) of this paragraph), a 'combined group' (as defined in subparagraph (4) of this paragraph) or an 'insurance group' (as defined in subparagraph (5) of this paragraph). For the exclusion of certain stock for purposes of applying the definitions contained in this paragraph, see section 1563(c) and § 1.1563-2.

. . . . .

(3) *Brother-sister controlled group.* (i) The term 'brother-sister controlled group' means two or more corporations if the same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of the rules contained in paragraph (b) of § 1.1563-3), singly or in combination, stock possessing—

(a) At least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation; and

(b) More than 50 percent of the total

combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.

(ii) The principles of this paragraph may be illustrated by the following examples:

Example (1). The outstanding stock of corporations P, Q, R, S, and T, which have only one class of stock outstanding, is owned by the following unrelated individuals:

	Corporations					Identical
Individuals	P	Q	R	S	T	Ownership
A	60%	60%	60%	60%	100%	60%
B	40%					
C		40%				
D			40%			
E				40%		
TOTAL	100%	100%	100%	100%	100%	60%

Corporations P, Q, R, S, and T are members of a brother-sister controlled group. . . ."

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No. 80-1251

In the Supreme Court of the United States

OCTOBER TERM, 1981

UNITED STATES OF AMERICA, PETITIONER

v.

VOGEL FERTILIZER COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

REPLY BRIEF FOR THE UNITED STATES

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REPLY BRIEF FOR THE UNITED STATES

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1. Simply put, our submission in this case is that the 80% and 50% tests of Section 1563(a)(2) are separate and distinct portions of the statute that must be independently applied in determining under what circumstances a group of corporations is entitled to only a single surtax exemption. When those tests are separately applied, in accordance with the literal terms of the statute, it is apparent that respondent Vogel Fertilizer and Vogel Popcorn are part of a "brother-sister controlled group."

The function of subparagraph (A) is to require that the corporations in question be closely held, at least to the extent of 80% of their stock. The function of subparagraph (B) is to require that there be identity of ownership to the extent of more than 50% between closely held corporations. Within any single group of five or fewer persons, each requirement must be fulfilled. If, within any such group of five or fewer persons, each requirement is fulfilled, the

statute is satisfied. Perhaps the function and operation of the statute can be best appreciated by examining initially cases that do not fall within it. Consider, for example:

Individuals	Corporations	
	S	T
A	12%	12%
B	12%	12%
C	12%	12%
D	12%	12%
E	13%	13%
F	13%	13%
G	13%	13%
H	13%	13%
	100%	100%

Here we have complete identity of ownership. Any group of five of the shareholders will own more than 50% of the stock in each corporation, in identical holdings. The 50% test of subparagraph (B) is clearly satisfied.

But there is not the required closeness of holding. No group of five or fewer can be found that owns 80% of the stock of either corporation. Subparagraph (A) is therefore not satisfied, and S and T are not members of a "brother-sister controlled group."

On the other hand, consider the following example:

Individuals	Corporations	
	U	V
A	5%	40%
B	5%	30%
C	10%	10%
D	10%	10%
E	30%	5%
F	40%	5%
	100%	100%

The corporations in this example are adequately closely held, because any one of the three groups of not more than five will satisfy the 80% test of subparagraph (A): ABCEF, ABDEF, or ABEF. But no one of these groups provides more than 30% identity of ownership, so the test of (B) is not satisfied, and U and V are not members of a "brother-sister controlled group."[1]

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[1] A simplified version of this non-qualifying example, with a single group of two might be:

Individuals	Corporations	
	Y	Z
A	80%	20%
B	20%	80%
	100%	100%

The result is different if the pattern is as follows:

Individuals	Corporations	
	W	X
A	15%	-
B	30%	-
C	55%	55%
D	-	30%
E	-	15%
	100%	100%

Each of the corporations is adequately closely held, since each is more than 80% owned by members of the group of five, so (A) is satisfied. There is identity of ownership of more than 50% by a member of the group of five, so (B) is satisfied, and W and X are members of a "brother-sister controlled group." That is what Section 1563(a)(2) commands. To add more is to interpolate provisions that are alien to the terms, the function, and the legislative history of the statute.

Here, the group is composed of shareholders Arthur Vogel and Richard Crain. As in the above example of W and X, there is more than 80% ownership of Vogel Fertilizer and of Vogel Popcorn within the group, so the requirement of subparagraph (A) is satisfied. And by virtue of the 77.49% identity in ownership by Arthur Vogel, the more-than-50% requirement of subparagraph (B) is satisfied. It is clear that 5 or fewer persons owned at least 80% of the combined voting power of stock of each corporation, and more than 50% of the total [voting stock] of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation. Vogel Fertilizer and Vogel Popcorn are therefore members of a "brother-sister controlled group."

Respondent and the *amici*, however, resist the force of the literal terms of the statute. By adding unstated conditions to the 80% test, they contend that the 80% test is not satisfied unless each member of the group owns some stock in each corporation. In support of this argument, respondent invokes (Br. 40-42) the "last antecedent doctrine" and claims that the final phrase in subparagraph (B)—"taking into account the stock ownership of each such person only to the extent that such stock ownership is identical with respect to each such corporation"—modifies the earlier statutory phrase "5 or fewer persons."

To be sure, the phrase in subparagraph (B) necessarily makes reference to the "5 or fewer persons" who comprise the shareholder group. But the last antedecent doctrine cannot operate to transport the phrase "each such person" from the 50% test of subparagraph (B) and make it operative for purposes of subparagraph (A). Surely if Congress wanted to introduce the commonality requirement of the 50% test into the 80% test it could have easily done so by employing the phrase "each such person" in subparagraph (A) as well. But Congress did not do so. Instead, it added the 50% test to the statute as a separate subparagraph presumably so that it would be separately applied. The structure of Section 1563(a)(2) therefore refutes respondent's "highly strained and convoluted reading of the statute." *Allen Oil Co.* v. *Commissioner*, 614 F. 2d 336, 339 (2d Cir. 1980).

2. The foregoing reading of the statute is confirmed by its underlying policy. In enacting Section 1563 in 1964 and amending the statute in 1969, Congress sought to establish an objective basis for disallowing multiple surtax exemptions of closely held corporations with such a degree of identity of ownership as to allow their common owners to operate the corporations as a single economic entity. It cannot be doubted that respondent Vogel Fertilizer and Vogel Popcorn are so operated. Arthur Vogel (77.49%) and

Richard Crain (22.51%) together own 100% of respondent, and Arthur Vogel owns 87.5% of Vogel Popcorn. Given these shareholdings, it is plain that Arthur Vogel can operate both corporations as a single economic entity.

Indeed, as we have pointed out, respondent and the decision below concede that if Richard Crain owned a single share of Vogel Popcorn, the two corporations would constitute a brother-sister controlled group, even under their reading of the statute. But Richard Crain's ownership of a single share of Vogel Popcorn would not in any manner enhance the ability of Arthur Vogel to operate both corporations as a single economic entity. There is absolutely no evidence that Congress intended Section 1563(a) to turn on such minute differences. Accordingly, the logical inference to be drawn is that the Treasury Regulation's interpretation of the statute furthers the legislative policy.

3. Contrary to respondent's further argument (Br. 10-38), Congress was well aware of the Treasury's intention to issue the Regulations at issue here that directly support our reading of the statute. As we have pointed out in greater detail in our opening brief (at 31-33), when Congress added the 50% test to Section 1563 to expand its coverage, it employed exactly the same words that it previously had used in Section 1551(b)(2) to describe a brother-sister controlled group of corporations.[2] Both the House Committee

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[2]Contrary to respondent's contention (Br. 5, 15), there is no difference in interpretation of the 1964 and 1969 statutes by the government. The different versions of the statutes relate to different situations. The "ludicrous situation" of respondent's imagining is a product of respondent's misinterpretation. As enacted in 1964, Section 1563(a)(2) defined "brother-sister controlled group" as "[t]wo or more corporations if stock possessing at least 80 percent of * * * voting power * * * or * * * of * * * value * * * of each of the corporations is owned * * * by one person" (Pub. L. No. 88-272, 78 Stat. 120). Since the "group" of owners could consist of only one person, it was not necessary to provide explicitly for identity of ownership. No feat of interpretation could

Report and the Treasury's Technical Explanation are in accord on this point that "[t]he stock ownership test [for brother-sister controlled groups] would be the same test employed in section 1551(b)(2) * * *." H.R. Rep. No. 91-413, Pt. 2, 91st Cong., ~~1st Cong~~., 1st Sess. 76 (1969). See also *Tax Reform, 1969: Hearings Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess., Pt. 14, 5168 (1969). At that time, Trea. Reg., Section 1.1551-1(g)(4) (26 C.F.R.) included an example (Example 4) indicating that the ownership of a person could be taken into account for purposes of the 80% test although he did not own stock in each of the corporations and was therefore not considered for purposes of the 50% test. Given the identical language of the two statutes and the inference to be drawn from the Section 1551 Regulations that supports the validity of the Section 1563 Regulation at issue here, there is no basis for respondent's claim that the latter Regulation goes beyond anything that the Treasury presented to Congress in 1969.

4. Finally, respondent relies (Br. 34-35) on the Tax Court's observation in *Fairfax Auto Parts of Northern Virginia, Inc.* v. *Commissioner*, 65 T.C. 798, 805 n.5 (1976), that the Treasury Regulation would permit a shareholder (such as Arthur Vogel) of one corporation to "surprise" his fellow shareholder (such as Richard Crain) by forming a second corporation and thereby cause the loss of

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bring Corporation X, solely owned by A, and Corporation Y, solely owned by B, within the statutory definition. When the ownership group was enlarged from "one person" in the 1964 statute to "5 or fewer persons" in Section 1563(a)(2), as amended in 1969 (Pub. L. No. 91-172, 83 Stat. 602), it was necessary to be explicit on identity of ownership, and subparagraph (B) supplied that need. Under the amended statute, if A and B owned all of the stock of Corporation X, and C, D, and E owned all of the stock of Corporation Y, it was the failure to meet the requirements of (B) that kept the two corporations from coming within the statutory definition. Within the group of "5 or fewer persons" all of the stock of each corporation is owned.

the first corporation's surtax exemption. As respondent views the matter (Br. 6-7). "Surely Congress did not intend that such an unfair surprise be visited upon * * * Richard Crain, under what must be a common fact pattern, because of actions taken by an individual over whom he has no control." Respondent therefore concludes (Br. 6) that "equitable considerations" support its claim to a full surtax exemption.

But the tax law is replete with instances in which the uncontrolled actions of a single individual can affect the tax liability of others. For example, a shareholder in a Subchapter S corporation can transfer shares to a person who is disqualified, thereby revoking the Subchapter S status of the corporation and altering the tax expectations of his fellow shareholders. See Section 1371 *et seq.* of the Code. Similarly, the managers of a pension plan may act in a manner that results in its disqualification and therefore cause onerous tax consequences to the participants. See Section 401 *et seq.* The same is true for an agricultural cooperative. See Section 1381 *et seq.* of the Code. And, finally, the managers of a tax-exempt institution may engage in activities that cause the revocation of its status and thereby jeopardize the deductible character of contributions made by third parties. See *Bob Jones University* v. *Simon*, 416 U.S. 725 (1974). While careful counsel may seek to mitigate the impact of such adverse tax consequences by requiring agreements to refrain from disqualifying activities and by providing for indemnification for breach of such agreements, there is no principle in the tax law that prevents the actions of one individual or entity from affecting the tax liability of another. At all events, respondent has made no showing that Arthur Vogel organized Vogel Popcorn after respondent came into existence without the knowledge of

Richard Crain. There is accordingly no legal or factual basis for respondent's "equitable" claim to a full corporate surtax exemption.[3]

CONCLUSION

For the reasons stated above and in our opening brief, the judgment of the Court of Claims should be reversed.

Respectfully submitted.

REX E. LEE
Solicitor General

OCTOBER 1981

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[3]It is also true that under respondent's interpretation of the statute, a person in Richard Crain's position could "surprise" a person in Arthur Vogel's position by acquiring a single share of stock of the corporation in which the person in Arthur Vogel's position owned 51% of the stock.

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In The

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OCTOBER TERM, 1980

No. 80-1251

UNITED STATES OF AMERICA,
Petitioner,

vs.

VOGEL FERTILIZER COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

MOTION FOR SPECIAL LEAVE TO FILE AN AMICUS CURIAE BRIEF AND BRIEF FOR AMICUS CURIAE DELTA METALFORMING COMPANY, INC. IN SUPPORT OF VOGEL FERTILIZER COMPANY, Respondent

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Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

MOTION FOR SPECIAL LEAVE TO FILE AN AMICUS CURIAE BRIEF

Interest of Movant in the Instant Case

Movant, Delta Metalforming Company, Inc. ("Delta") is the respondent in another case presently before the Court, *Commissioner of Internal Revenue, Petitioner v. Delta Metalforming Co., Inc., Respondent,* No. 80-1499, which involves the same legal issue as does the instant case. Delta timely filed a motion to consolidate the two cases for purposes of argument,

but its motion was denied. Delta has just received copies of the briefs of the United States and of Vogel Fertilizer Company, and believes that certain non-tautological observations would be useful to the Court.

Argument for Granting Permission to File an Amicus Curiae Brief.

Delta recognizes that the usual time limitation for filing a motion for leave to file an *amicus curiae* brief under Rule 34 of the Rules of the Court has expired. Delta nonetheless respectfully requests that the Court grant permission for Delta to file an *amicus curiae* brief because the facts of *Commissioner of Internal Revenue, Petitioner v. Delta Metalforming Co., Inc., Respondent,* No. 80-1499, already pending before the Court, highlight certain aspects of the legal issues presented in both this case and case No. 80-1499 which were not adequately presented in the principal briefs of Petitioner, Respondent and *Amici Curiae* Dixie Realty Co., et al in this case.

Delta's timely motion to consolidate case No. 80-1499 with this case for purposes of argument has been denied and no other means are available for presentation to the Court of certain relevant considerations. Delta therefore respectfully moves that the Court grant it leave to file this *amicus curiae* brief under the general power of the Court to govern the administration of cases.

BRIEF FOR AMICUS CURIAE

Summary of Argument.

The "single share" argument — that had Richard

Crain held just one share of stock the government's position would be correct — is without merit. The very nature of an objective standard is to select some clearly defined point as a basis for making distinctions. Furthermore, the holding of but a single share confers significant rights which a non-shareholder does not have.

The Treasury regulations should be accorded no presumption of correctness because the Treasury wrote and interpreted the statute for Congress, and then adopted regulations which exceeded the scope of the Treasury's presentation to Congress; under these circumstances the statute should be construed against the Treasury's subsequent expanded interpretation.

Argument

1. *A Single Share*

On Pages 10 and 20 of the Brief for the United States, the Solicitor General states that "the most telling point" against the statutory interpretation by the Court of Claims is that under that Court's view, Vogel Popcorn would have constituted a brother-sister control group if Richard Cain owned but a single share of Vogel Popcorn. Whenever a mathematical or numerical standard is used, obviously, failure to meet the standard by the smallest integer is the most difficult position to justify — such is the nature of numerical standards. Indeed, under §1563(e)(5)(A) of the Code, the very section under consideration, the direct ownership of but a single share of stock precludes a spouse from avoiding certain attribution rules. See also Treas. Reg. § 1.1563-3(b)(5)(ii)(a). The government's untenable

argument — which it views as "the most telling point" — is evidence, strong evidence, of the meritless position of the government in this case.

Ownership of only one share of stock in a corporation has significant substantive benefits. Even a single share in the formative years of a company such as Xerox or Apple Computer would have had significant economic value. If the one share were one of 10 shares outstanding, it would be a material part of the ownership. The difference between owning no shares and one share is the most significant integral step in stock ownership. The owner of a single share has the right to sue an officer or director of the corporation who breaches his fiduciary responsibility to the corporation and to prevent, for examples, excessive salaries and other acts of self-dealing. He also has standing to sue under the Securities Exchange Act of 1934. See *Rekant v. Desser,* 425 F.2d 872 at 876 (5th Cir. 1970), where a shareholder with six shares of admittedly "practically worthless" stock had standing to sue under 10(b) of the Securities Exchange Act of 1934).[1] A holder of only one share has the opportunity to see corporate records, which could include significant economic data valuable to the shareholder. Ownership of a single share means being in, not out, being a participant, a sharer, an owner, a proprietor, being able to talk of "my company". The Code encourages employee stock ownership, and even gives tax credits for corporations to provide employee ownership; IRC § 46(a)(2)(A) (iii) and (E) and

[1] In footnote 9, J. Wisdom said: "It is a disconcerting thought that a shareholder with his tiny holding should have access to as powerful a weapon as 10(b). The plaintiff, however, is in a fiduciary relationship to the other shareholders as a consequence of bringing a derivative action in a class action."

§ 48(n), see also IRC § 422A and § 402(e)(4)(J). For the government to argue that stock ownership is meaningless is cant.

The importance of the distinction between owning shares and not owning shares is clearly demonstrated in the case of Delta Metalforming Co., Inc. ("Delta"). Delta's case involves three corporations, two of which are roughly equally owned by four individuals and the third, Delta, by only three individuals. See the government's Petition for a Writ of Certiorari in case No. 80-1499 at page 2. Not only does this fourth individual, F.T. Sharp, have no economic, securities, law, or dissenting shareholder rights vis-a-vis Delta, but the balance of power within the Delta corporation is significantly different from that of the two other corporations because of his non-ownership of any shares. Any two Delta shareholders may approve even corporate actions requiring a two-thirds vote for Delta, but these same two shareholders could not do so in either of the two other corporations without convincing F. T. Sharp to join them.[2] The "missing" shareholder, although obviously unnecessary in obtaining shareholder approval of Delta corporate action, holds a balance of power regarding matters requiring two-thirds shareholder approval in the two other corporations, and the fact that this shareholder owns no shares in Delta

[2] The Texas Business Corporation Act, applicable to Delta, generally requires two-thirds shareholder approval for amendment of the Articles of Incorporation, mergers, consolidations, voluntary dissolution, revocation of dissolution proceedings, distributions out of reductions in stated capital, the corporation's purchase of its own shares other than from earned surplus and any other matter stated in the Articles of Incorporation as requiring two-thirds approval. See Hamilton, *Texas Practice*, Vol. 19 § 499.

cannot therefore be regarded, as the government urges, to be of no consequence.

2. *Square Corners*

The Treasury initiated the changes to section 1563(a)(2) and presented Congress with examples of why these changes were necessary. Brief for *Amici Curiae* Dixie Realty Company, Inc., et al, Pp. 24-25. For the Treasury to enlarge its own interpretation after Congress has adopted the Treasury position is not cutting square corners with taxpayers. Credence should not be given to the government's argument that the Treasury's interpretation reflects Congressional intent because it was the Treasury who initiated the entire change and presented to Congress the examples and reasons for the change, none of which included the interpretation the Treasury now proposes. This leads to the conclusion that the Treasury at the time it presented the proposal to Congress did not believe that the proposal then meant what the Solicitor General contends it now means. Presumably the Treasury did not intentionally withhold from Congress a different intent. The Treasury should have known what it was doing when it submitted the proposal to Congress, and, as the author of the statute, should not now be permitted to argue that its hindsight interpretation should be sustained on the ground of presumptive correctness.

CONCLUSION

The Court should affirm the decision of the Court of Claims for the reason stated here and in the briefs of Vogel Fertilizer Company and Dixie Realty Company, et al.

Respectfully submitted

.....

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September 28, 1981.

CERTIFICATE OF SERVICE

Counsel certifies that service of this motion and brief has been made on counsel for petitioner in compliance with U.S. Supreme Court Rules 22.1, 28.3 and 28.4(a) by mailing three copies hereof by registered mail, return receipt requested, first-class postage pre-paid to Wade H. McCree, Jr., Solicitor General, Department of Justice, Washington, D.C. 20530 on September 28, 1981, and that three copies of this motion and brief have been mailed in like manner to Ronald C. Jensen of Baird, Holm, McEachen, Pendersen, Hamann & Haggart, counsel for respondent, at 1500 Woodmen Tower, Omaha, Nebraska 68102.

.....

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STATEMENT OF FILING

Counsel certifies by a signed and notarized statement that, to the knowledge of counsel as a member of the Bar of this Court, this motion and brief is duly filed with this Court in compliance with U.S. Supreme Court Rules 22.1 and 28.2 by deposit of 40 copies thereof in a United States post office or mailbox with first-class postage prepaid and addressed to the Clerk of the Court on September 28, 1981.

.....

Neil J. O'Brien
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THE STATE OF TEXAS)
)
COUNTY OF DALLAS)

The above statement has been SUBSCRIBED AND SWORN TO BEFORE ME on the twenty-eighth day of September, 1981, to certify which witness my hand and official seal.

(SEAL)

.....

Notary Public, State of Texas

Office Supreme Court, U.S.
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CLERK

No. 80-1251

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1980.

UNITED STATES OF AMERICA,

Petitioner,

v.

VOGEL FERTILIZER COMPANY,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR AMICI CURIAE DIXIE REALTY COMPANY, INC. and DIXIE FURNITURE CO., INC. IN SUPPORT OF VOGEL FERTILIZER COMPANY, Respondent

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1980

No. 80-1251

UNITED STATES OF AMERICA,

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR AMICI CURIAE DIXIE REALTY COMPANY, INC. and DIXIE FURNITURE CO., INC. IN SUPPORT OF VOGEL FERTILIZER COMPANY, Respondent

This brief is submitted on behalf of Dixie Realty Company, Inc. and Dixie Furniture Co., Inc., as *amici curiae*, in support of Respondent Vogel Fertilizer Company pursuant to Rule 36 of this Court by written consent of all the parties to the case.[1]

[1] Copies of letters dated July 6, 1981, and July 7, 1981, from counsel representing the parties in this case consenting to the filing by Dixie Realty Company, Inc. and Dixie Furniture Co., Inc., as

[footnote continued]

Section 1561(a)(1) of the Internal Revenue Code of 1954 (I.R.C. §1561(a)(1)), provides that a controlled group of corporations shall be limited to one surtax exemption under Section 11(d). Section 1563(a)(2) provides a two-pronged test of stock ownership – an 80% test and a 50% test – in order to determine whether two or more corporations which are related by certain stock ownership interests of their shareholders constitute a brother-sister controlled group of corporations. In interpreting Section 1563, the Treasury has promulgated in Treasury Regulation §1.1563-1(a)(3) (1969) that for purposes of the 80% test, while the group of shareholders of five or fewer persons must, in the aggregate, own at least 80% of each of the corporations constituting the controlled group, each of the same such persons in the ownership group are not required to own stock in each corporate member of the group.

Petitioner seeks to reverse the decision of the Court of Claims which invalidated Treasury Regulation §1.1563-1 (a)(3) on the basis that it was "clearly inconsistent with the legislative history and unreasonable when the purpose as well as the bare words of the statute [Section 1563(a) (2) of the Internal Revenue Code of 1954 (26 U.S.C.)] are considered." (Pet. App. 12a). The Court of Claims concluded that a person must own stock in each entity of the brother-sister controlled group in order for a person's stock ownership to be taken into account for purposes of the 80% test of Section 1563(a)(2)(A).

INTEREST OF THE AMICI CURIAE

Dixie Realty Company, Inc. ("Dixie Realty"), an Arkansas corporation engaged in the business of owning

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amici curiae, have been presented and filed with the Court within the time for filing the brief of the Respondent.

and leasing real property, and Dixie Furniture Co., Inc. ("Dixie Furniture"), an Arkansas corporation engaged in the retail sale of furniture, filed a timely appeal in the United States Court of Appeals for the Eighth Circuit (No. 80-2183) from a decision of the United States Tax Court (*Dixie Realty Company, Inc. v. Commissioner*, T.C. Memo 1980-287, 40 T.C.M. (C.C.H.) 868 (1980)), which upheld the determination by the Commissioner of Internal Revenue of a deficiency assessed against Dixie Realty and Dixie Furniture on the basis that they were members of a "brother-sister" controlled group of corporations under Section 1563(a)(2) of the Internal Revenue Code.[2]

The question presented for resolution in *Dixie Realty Company, Inc. v. Commissioner*, No. 80-2183 (8th Cir., filed December 18, 1980) is identical to that presented to the Court in this case. The question to be decided is whether it is a requirement of Section 1563(a)(2) of the Internal Revenue Code of 1954, defining "brother-sister" controlled groups, that a stockholder own stock in *each* corporation of the group before his stock may be counted for purposes of the 80% test of Section 1563(a)(2)(A)

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[2] Although the Tax Court did not agree with the Commissioner of Internal Revenue on the validity of its interpretation of Section 1563(a)(2) (having previously ruled in favor of the taxpayer and holding Treas. Reg. §1.1561-1(a)(3) (1969) to be unlawful in Fairfax Auto Parts of Northern Virginia, Inc. v. Commissioner, 65 T.C. 798 (1976), *rev'd and remanded*, 548 F.2d 501 (4th Cir. 1977), *cert. denied*, 434 U.S. 904 (1977)), it decided in favor of the Treasury because it was "constrained" under the authority of Golsen v. Commissioner, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), *cert. denied*, 404 U.S. 940 (1971), to follow the Eighth Circuit Court's earlier decision on the same issues in T.L. Hunt, Inc. v. Commissioner, 562 F.2d 532 (8th Cir. 1977).

or whether the statute is met by a "5 or fewer" persons who own stock "singly or in combination" as set forth in the governing Treasury regulation.[3]

Following the filing of the petition for writ of certiorari to the Court of Claims by the United States in this case, Dixie Realty and Dixie Furniture filed a Consent Motion to Stay Proceedings and Briefing Schedule pending a determination of whether the Court would grant the petition for a writ of certiorari of the United States in this case. The United States Court of Appeals for the Eighth Circuit denied the Motion and briefs were filed by the parties. Contemporaneous with the filing of its Reply Brief on May 11, 1981, Dixie Realty and Dixie Furniture filed a Renewed Motion for Stay of Proceedings or, In the Alternative, To Waive Oral Argument and for an Expedited Decision in light of the granting of the petition for writ of certiorari in this case, which renewed motion was granted by the United States Court of Appeals for the Eighth Circuit on June 5, 1981.

The decision of the Court of Claims and review by the Court has immediate and substantial impact on Dixie Realty and Dixie Furniture. Dixie Realty and Dixie Furniture believe that their analysis of the important aspects of the statute, legislative history and legislative purpose critical to determination of the question presented for review will be of material aid to the Court.

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[3]The identical issue is also before this Court in Delta Metalforming Co. v. Commissioner, 632 F.2d 442 (5th Cir. 1980), *petition for cert. pending*, No. 80-1499 (filed Mar. 4, 1981), as well as before the Ninth Circuit in Baloaian v. Commissioner, Nos. 78-2438 and 78-2508, and before the Sixth Circuit in Davidson Chevrolet Co. v. Commissioner, No. 80-1041.

SUMMARY OF ARGUMENT

The Treasury's interpretation of Section 1563(a)(2)(A), Internal Revenue Code of 1954 (IRC §1563(a)) as set forth in Treasury Regulation §1.1563-1(a)(3) (1969) is not supported by a plain meaning of the language of the statute or by an analysis of the legislative history and of the Congressional intent in adopting the statute and, therefore, the rule of deference normally accorded the Commissioner of Internal Revenue in interpreting the tax laws is inapplicable. Moreover "weighty reasons" are present in this case compelling that the Court not apply the normal rule of deference. The legislative history of Section 1563(a)(2)(A) of the Internal Revenue Code of 1954 clearly does not support the Commissioner's interpretation that the statute is satisfied if "five or fewer persons" own stock "singly or in combination." Rather, the legislative history mandates that for the purpose of the 80% test, "five or fewer persons" must own stock in *each* corporation of the group before the shareholders can be counted for the purpose of the 80% test.

A careful examination of the Treasury's addition of the words "singly or in combination" to the statute of Treasury Regulation §1.1563-1(a)(3) distorts the intent of Congress. In this respect, the statute is definitional and constitutes a decision by Congress to replace the prior subjective standard with an objective test. The Commissioner should not and does not have the authority to legally expand the definitional standard established by Congress.

An examination of the legislative history to the 1969 Amendment of Section 1563(a)(2) confirms that the 80% test, contrary to the effect of the Treasury's regulation, was intended to be meaningful, and the 50% test was

created as a limitation of the 80% common ownership requirement. Examination of the Treasury's GENERAL EXPLANATION OF TREASURY TAX REFORM PROPOSALS BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS, 91st Cong., 1st Sess., Pt. 14, at 5394 (1969), shows that the purpose of the 1969 change was to increase the number of shareholders who could comprise the controlled group from one to five. Further, the Treasury's TECHNICAL EXPLANATION OF TREASURY TAX REFORM PROPOSALS BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS, 91st Cong., 1st Sess., Pt. 14, at 9162 (1969), demonstrates that the *same* persons were expected to comprise the ownership group for the purposes of the 80% test and the 50% test. Contrary to the regulation adopted, all of the examples furnished by the Treasury to the Congress illustrating the 1969 amendment to Section 1563 included the requirement of common ownership in each corporation.

The Treasury's interpretation of Section 1563(a)(2) results in the onerous and implausible result of subjecting an expanded group of minority shareholders in corporations to the possibility of deprivation of tax benefits otherwise available without their prior knowledge or participation. This is clearly inconsistent with the intent of Congress. Moreover, accepting the Treasury's position allows an unfair and unexpected result that the Treasury may present one view of legislation to Congress prior to enactment and adopt another view after enactment, thereby expanding and changing the statute adopted by Congress. Such a result is a "gross usurpation of the power of Congress." *Vogel Fertilizer Company v. United States,* 434 F.2d 497, 508 (Ct.Cl. 1980) (Pet. App. 25a).

ARGUMENT

THE TREASURY'S DEFINITION OF A BROTHER-SISTER CONTROLLED GROUP OF CORPORATIONS SET FORTH IN TREAS. REG. §1.1563-1(a)(3) IS AN IMPROPER AND UNREASONABLE INTERPRETATION OF THE LANGUAGE OF THE STATUTE.

From the first moment of its promulgation and continuing into the present, Treas. Reg. §1.1563-1(a)(3) (1969) (sometimes referred to as "Regulation") has met with a storm of criticism from academics and members of the tax bar.[4] The almost unanimous reaction of those persons experienced with the background and development of the 1969 amendment of Section 1563(a)(2) has been that the Treasury's interpretation of the 80% test was unreasonable and improper. As a general rule, the Court does not overturn "contemporaneous constructions by those charged with administration of" the Internal Revenue Code, most often applying a rule of deference which

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[4] *See* Bonovitz, *Brother-Sister Controlled Groups Under Section 1563: The 80 Percent Ownership Test*, 28 TAX LAWYER 511 (1975); Pearlman, *Recasting the Multiple Corporate Group After the Multiple Surtax Exemption Ends*, 41 J. TAXATION 194 (1974); Thomas, *Brother-Sister Multiple Corporations The Tax Reform Act of 1969 Reformed by Regulation*, 28 TAX L. REV. 65 (1972); Kringel, *Multiple Corporation Proposed Regulations Raise More Questions Than They Answer*, 36 J. TAXATION 353 (1972); Libin & Abramowitz, *Multiple Corporations: A Surprising Interpretation of Sec. 1563(a)(2) and Temporary Regulations*, 3 TAX ADVISOR 326 (1971). *See also* Note, *Disallowance of Surtax Exemption to Brother-Sister Corporation Stock Ownership Test Under Sections 1551 and 1563*, 1976 BRIGHAM YOUNG L. REV. 1000, 1017; Weisman, *Brother-Sister Controlled Corporations: On and Off the Road To the Supreme Court With and Edsel*, 1978 TAXES 475. *But see* White, *The Tax Reform Act of 1969, Demise of Multiple Surtax Exemptions – When Too Much of a Good Thing Proved Its Own Undoing*, 16 WAYNE L. REV. 1353 (1970).

places a heavy burden on the taxpayer who seeks to challenge the Commissioner's interpretation of a statute. *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948). This normal rule of deference which was most recently stated by the Court this term in *Commissioner v. Portland Cement Co. of Utah*, ___ U.S. ___, 101 S.Ct. 1037, 1045 (1981) defers to Treasury Regulations that implement the congressional mandate in some reasonable manner." *United States v. Correll*, 389 U.S. 299, 307 (1967); *See also United States v. Cartwright*, 411 U.S. 546, 550 (1973); *Fulman v. United States*, 434 U.S. 528, 533 (1978); *National Muffler Dealers Assn. v. United States*, 440 U.S. 472, 476-77 (1979); *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 533 n.11 (1979). Notwithstanding the rule of deference, however, "weighty reasons" for invalidating a regulation exist when a regulation achieves a result which is unreasonable and inconsistent with the express language of the statute, or which is not supported by the statute's legislative history. *United States v. Cartwright, supra* 411 U.S. at 550; *National Muffler Dealers Assn., Inc. v. United States, supra* 440 U.S. at 476-477. As will be discussed in this brief, "weighty reasons" exist for the Court not to defer to the Treasury's expansive and unreasonable interpretation of Section 1563 which was adopted in Treas. Reg. §1.1563-1(a)(3) (1969).

In the case of Section 1563(a)(2) there is sufficient reason to require a strict construction of the language of the statute and not to apply the normal presumption in favor of a Treasury regulation. As recognized by the Court of Claims, the rule of deference is not appropriate when the Treasury is providing a definition to fit the statute, and the sole issue is whether persons in the position of the taxpayers are covered by the statute. (Pet.

App. 33a). The Commissioner has no power to add to the Internal Revenue Code that which he may believe Congress overlooked or deliberately omitted. *See e.g. Helvering v. Credit Alliance Corp.*, 316 U.S. 107, 113 (1942). Since Section 1563(a)(2) is definitional, it should not be applied beyond a narrow application without specific congressional approval. That is, the underlying effect of Section 1563 was to replace a subjective test of common ownership with an objective test. To the extent the Treasury is allowed to impose an expansive interpretation upon the taxpayer, it changes the original definition adopted by Congress.[5] The Court of Claims in addressing this issue noted that it would be "inappropriate for the application of the principle of deference in this case where [the] sole question here is whether the 80-percent provision requires that the five or fewer persons involved each hold stock in all of the brother-sister corporations. The answer to that question turns [in this case] upon the statutory language, the legislative history, and the basic purpose and design of the legislation." (Pet. App. 33a).

The distinction between a definitional statutory provision which involves a mathematical test rather than a statute which involves an interpretational function by the Treasury is critical to an application of the rule of deference by the Court in this case. In this respect, Section 1563(a) differs from Section 611, which was the subject of the Court's decision in *Commissioner v. Portland Cement Co. of Utah, supra,* and unlike that case

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[5]Prior to enactment of Section 1563 in 1964, Sections 269, 482 and 1551 were the Internal Revenue Service's sole vehicles for attacking the use of multiple corporations to achieve tax benefits. Each of these sections required a showing of an improper tax motive in the use of more than one corporation.

does *not* involve a specific delegation to the Commissioner to define by regulation the controlled group of stockholders. Similarly, the Regulation does not involve an instance of the Treasury supplying definitions which were otherwise omitted by Congress but necessary to interpret the statutes as for example in *Bingler v. Johnson,* 394 U.S. 741 (1969); or a statute which on its face "vest(s) the Commissioner with wide discretion" in order to determine the stock ownership requirements which are themselves the threshold requirements of the statute. *Thor Power Tool Co. v. Commissioner, supra,* 439 U.S. 522, 533 (1979). The test of stock ownership imposed by Congress is a clear and unambiguous objective line drawing to replace a previous subjective test. The objective test is satisfied when the threshold requirement is met that a person own stock in each of the corporations involved before applying either the 80% or 50% test. As noted by the Fifth Circuit, the court, "particularly in the area of federal taxation, . . . should not ignore percentage requirements obviously and specifically fixed by Congress." *Delta Metalforming, Inc. v. Commissioner, supra,* 632 F.2d at 450.

A reading of the language of Section 1563(a)(2) does not justify the Treasury's expansive interpretation of the statute. In *Fairfax Auto Parts of Northern Virginia, Inc. v. Commissioner,* 65 T.C. 798 (1976), *rev'd and remanded,* 548 F.2d 501 (4th Cir. 1977), the Tax Court analyzed the language of Section 1563(a)(2) and concluded that the Treasury's addition in the Regulation was an "unwarranted extension of the statutory language of Section 1563(a)(2)." Similarly, as concluded by the Court of Claims, and the Fifth Circuit in *Delta Metalforming Co., Inc., supra,* the plain meaning of the language of the statute cannot and does not support the

Treasury's interpretation as set forth by it in Treas. Reg. §1.1563-1(a)(3). Nowhere in the statute is there included the words "singly or in combination thereof."

The term "controlled group of corporations" is defined in Section 1563(a)(2) to mean a "brother-sister" controlled group of corporations with the significant words of the statute being:

> (2) . . . Two or more corporations if *5 or fewer persons* . . . own . . .
>
> (A) at least 80 percent of the stock of each corporation, *and*
>
> (B) more than 50 percent of the stock of each corporation, taking into account the stock ownership of *each such person* only to the extent such stock ownership is identical with respect to each such corporation. (Emphasis added).

Contrary to the language of the statute emphasized herein, the Petitioner (Pet. Brief at 20) has sought to highlight only the identical ownership requirement in the 50% test. Such a reading ignores the proper thrust of the language of the statute, by overlooking the importance that the words "5 or fewer persons" are the subject of both the 80% and 50% test. Further the two tests are conjunctive, and the terms "each such person" in the 50% test refer directly back to the antecedent "5 or fewer persons." In construing the meaning of the statute, the Fifth Circuit in *Delta Metalforming Co., Inc., supra* 632 F.2d at 446, found that "[s]ince the same words apply to both tests, and the tests are characterized by sibling kinship, it would then make sense that the very same five or fewer persons should satisfy both tests. Further, the 50% test uses the language 'each such person' in describing the nature of the group. The grammatical antecedent for 'each such person' is 'five or fewer per-

sons.' Since the phrase 'five or fewer persons' is the antecedent for the 80% test as well as the 50% test, it is reasonable to conclude that 'each such person' in the second test would also apply to the first."

Contrary to Petitioner's view and that of the Second Circuit in *Allen Oil Co. v. Commissioner,* 614 F.2d 336, 339 (1980), the Court of Claims reading of the plain meaning of the statute does not "seriously weaken" the overlapping ownership required by the 80% test and the identical ownership required by the 50% test. As explained by the Court of Claims, the requirement that a person own stock in each of the corporations as a precondition of inclusion in the 80% test "merely requires the same persons to be in the group of controlling stockholders used in both tests." (Pet. App. 10a-11a). This view (as will be further discussed *infra* at 15) is consistent with the functions intended for each test. Moreover, the continued value of the 80% test itself is eliminated as a meaningful test if the Treasury's interpretation is applied. As pointed out by the Fifth Circuit, "[a]s we see it, the 80% ownership requirement in conjunction with the 50% identical ownership requirement work best in tandem. Each has a significant correspondent purpose and the stockholding requirements should be interpreted to ascribe to each a function that renders neither superfluous, dominant, or subordinate." *Delta Metalforming Co., Inc. v. Commissioner, supra* 632 F.2d at 450.

A reading of the plain language of the statute does not support the Treasury's regulation. Notwithstanding the strength of this conclusion, assuming *arguendo* that there is an ambiguity in Section 1563 (albeit tortuous), this factor does not in and of itself justify a conclusion that deference by the Court should be given to the interpre-

tation adopted by the Commissioner of Internal Revenue because there is some *possibility* that a rational relationship exists between the language of the statute and the regulation. When read in the context of the legislative purpose the statute was intended to serve, the Treasury's interpretation of Section 1563 is unreasonable and inconsistent with the statute.

In the case of a statute which may be subject to more than one interpretation, the Commissioner cannot select an interpretation which, though not plainly inconsistent on its face with the underlying statute, is unrealistic in light of Congress' intent, or fails to implement the congressional mandate in a reasonable manner. *United States v. Cartwright, supra* 411 U.S. at 550; *National Muffler Dealers Assn., Inc. v. United States, supra* 440 U.S. at 476-477; *Delta Metalforming Co., Inc. v. Commissioner, supra* 632 F.2d at 449, *petition for cert. pending,* No. 80-1499 (filed Mar. 4, 1981). If the validity of Treas. Reg. §1.1563-1(a)(3) cannot be finally determined from a reading of the plain meaning of the language of Section 1563(a)(2), the regulation must be measured against the legislative history of the statute; and if it prescribes a result which is not consistent with that which Congress intended, then the regulation must be declared invalid.

The most recent example of the Court's unwillingness to apply the rule of deference to a Treasury regulation occurred this term in *Rowan Companies, Inc. v. United States,* ___ U.S. ___ , 101 S.Ct. 2288 (1981). In that case, the Court overturned the Treasury's regulation interpreting the definition of "wages" in FICA and FUTA for failing to implement the statutory definition in a consistent or reasonable manner, finding that the plain meaning and legislative history of the statute did not support the Treasury's interpretation. As in that

case, Congress in adopting Section 1563(a) specifically set forth the percentage and common ownership requirements necessary for triggering the 80% test and the 50% test. Because the definition is set forth by Congress in the statute, the Treasury's interpretation is owed "less deference than a regulation issued under a specific grant of authority to define a statutory term or prescribe a statutory provision." *Rowan Companies, Inc. v. United States, supra* at 2292.[6] It is after an examination of the legislative history, origin and purpose of Section 1563-(a)(2) pertaining to the 80% test and 50% test that any ambiguity in the plain meaning of the statute is clearly resolved against the Treasury's expanded definition of the stock ownership required to bring taxpayers into the ambit of what Congress originally intended brother-sister controlled corporations to be.

TREAS. REG. §1.1563-1(a)(3) IS INVALID BECAUSE IT PRESCRIBES A RESULT WHICH IS NOT CONSISTENT WITH THE LEGISLATIVE HISTORY AND THE PURPOSE OF SECTION 1563(a)(2).

A. As A Result Of The Treasury's Misconstruction Of Section 1563(a)(2), The 80% Test And The 50% Test Are Being Used In A Way That Was Never Intended By Congress.

Prior to the amendment of Section 1563(a)(2) in 1969, the definition of a brother-sister controlled group

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[6]One important factor in *Rowan Companies, Inc. v. United States, supra,* involved the Treasury's inconsistent interpretation of the term "wages" under regulations first adopted in 1936 and later changed by the Treasury in 1940. Similarly, in the present case, the Treasury's inconsistency in interpreting the statute is evidenced by the different interpretation and examples offered to Congress prior to adoption of the 1969 amendment to Section 1563(a) when compared with the regulation adopted after enactment.

was limited to situations where 80% of the ownership of each of two or more corporations was vested in one person. Section 1563(a)(2) as it read before the Tax Reform Act of 1969 provided that a brother-sister group existed where an individual, estate or trust owned at least 80% of the voting power or value of the stock of two or more corporations. 26 U.S.C. §1563(a)(2), P.L. 88-272, 78 Stat. 25 (1964). In order to broaden the application of 1563(a)(2) to include corporations which operated as one economic entity, the amendment increased the number of shareholders that could be considered in determining if the requisite common control was present from one to five.

The Treasury's key addition to the statutory language in Treas. Reg. §1.1563-1(a)(3) is the provision that the stock ownership of the same five or fewer persons should be considered "singly or in combination." As appears from Example 1 of the Regulation,[7] the language removes the common ownership requirement from the 80% test and permits a person to be treated as one of the five or fewer persons comprising the group of controlling shareholders even though such person holds stock only in one corporation.

The effect of the Regulation is to make the 50% test the primary test and to relegate the 80% test to a minor role. (Pet. App. 23a). *Delta Metalforming Co., Inc. v. Commissioner, supra* 632 F.2d at 450; *T.L. Hunt, Inc., v. Commissioner, supra* 562 F.2d at 536 (Webster, J., dissenting). This follows because, if the 50% test is satisfied by one person who owns more than 50% of the stock in each corporation, the 80% test may be satisfied by any combination of four or fewer shareholders who in the aggregate own 30% of the stock in each corporation but

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[7] Ex. 1 of Reg. §1.1563-1(a)(3)(ii).

who individually may own stock in only one of the corporations in the group. There is little gained by including minority shareholders who have no common financial interests with one another in a controlled group simply because in the aggregate they own 30% of the stock in two or more corporations. Bonovitz, *Brother-Sister Controlled Groups Under Section 1963: The 80 Percent Ownership Test,* 28 TAX LAWYER 511 (1975). In the opinion of one commentator: "To interpret the statute so that the 80% test can be met by persons having ownership in only one corporation ignores the obvious relationship between the 50% test and the 80% test, *i.e.*, the exercise of control by persons with a substantial financial interest in the corporations . . . The features which make several corporations similar to one corporation is the exercise of control by a few persons over several corporations to further the substantial financial interest of *these* persons in *all* such corporations. If the statute is to test for the pattern of ownership where this feature will be present, then it must be interpreted to require that only the stock of persons with at least some stock in each corporation be counted in meeting the 80% test." Thomas, *Brother-Sister Multiple Corporations — The Tax Reform Act of 1969 Reformed by Regulation,* TAX L. REV. 65, 83 (1972). (Emphasis supplied).

The legislative history to the 1969 amendment of Section 1563(a)(2) clearly indicates that a meaningful independent role was intended for the 80% test of Section 1563(a)(2)(A) which, consistent with its use in the predecessor provisions to Section 1563(a)(2), was designed to be a measure of the common financial interest of shareholders comprising the alleged controlled group. The only significant legislative material on the 1969 change is the Treasury Department's General and Technical Explanations of its proposals which confirm that the 80% test was intended to be meaningful, and that

the 50% test was created as a limitation on the 80% test in certain situations.[8]

The Treasury's General Explanation demonstrates that the purpose of the 1969 amendment was to increase the number of shareholders that could comprise the controlled group from one to five. It did not change the prior existing stock ownership pattern. In addition, the "50 percent control test" was to insure that such common

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[8]The pertinent sections of the Treasury's General Explanation provide:

> (2) *Brother-sister groups.* — A group of corporations in which five or fewer persons own, to a large extent in identical proportions, at least 80 percent of the stock of each of the corporations. This provision expands present law by considering the combined stock ownership of five individuals rather than one individual, in applying the 80-percent test. Even the mild 6-percent penalty under existing law for brother-sister corporations claiming multiple surtax exemptions is largely ineffectual because of the present requirement that one person own 80 percent of the stock of each corporation before the group is subject to the penalty.
>
> However, in order to insure that this expanded definition of brother-sister controlled group applies only to those cases where the five or fewer individuals hold their 80 percent in a way which allows them to operate the corporations as one economic entity, the proposal would add an additional rule that the ownership of the five or fewer individuals must constitute more than 50 percent of the stock of each corporation considering, in this test of ownership, stock of a particular person only to the extent that it is owned identically with respect to each corporation.
>
> Thus, even where the 80 percent ownership test is met, the brother-sister definition will not apply unless the stockholdings of the individuals in the various corporations also meet the 50-percent identical ownership test. (Footnote omitted).

GENERAL EXPLANATION OF TREASURY TAX REFORM PROPOSALS IN HEARINGS ON THE SUBJECT OF TAX REFORM BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS, 91st Cong., 1st Sess., Pt. 14, at 5394 (1969) (sometimes referred to as "General Explanation").

stock ownership is for the most part ("to a large extent") *identical.* Moreover, as noted by the Court of Claims, if the significant change in the statute was intended to have been "removal of the requirement in the prior version of the 80-percent test that each shareholder must own some stock in each corporation," rather than the expansion of the number of stockholders considered from one to five, the Treasury's Explanation would have said much more when it stated the amendment's purpose. (Pet. App. 22a). The correctness of this interpretation is confirmed by the fact that in every example offered by the Treasury in its explanation involving the 80% test, the *persons* mentioned in each example *own* some *stock* in *each* corporation.

Petitioner's argument regarding the General Explanation (Pet. Brief 29) is at best strained. It attempts to read the language of the General Explanation without reconciling its interpretation with the remaining text or with the origin of the statute. Moreover, it glosses over the fact that the expansion which the Treasury seeks of the stock ownership in the 80% test is not addressed or supported in the text nor supported by Treasury's own examples. Further, the General Explanation is "totally inconsistent with the relatively minor role relegated to the 80-percent test by Treas. Reg. §1.-1563-1(a)(3)."[9] (Pet. App. 23a.)

The Treasury Technical Explanation is further compelling evidence that the same persons were expected to comprise the ownership group for purposes of the

[9]The General Explanation states: "Thus, even where the 80 percent ownership test is met, the brother-sister definition will not apply unless the stockholdings of the individuals in the various corporations also meet the 50-percent identical ownership test." The emphasis of the sentence on the 80-percent test as the primary requirement belies the notion that the 80-percent test was intended to measure only the number of stockholders and not the extent of overlapping stock ownership.

80% test and the 50% test. The pertinent part of the Technical Explanation stated:

> "Brother-sister controlled group. *Present law* defines a brother-sister controlled group as a group of corporations in which the voting stock or value of shares of each member is owned 80 percent by the same person (i.e. individual, estate or trust). Under the proposal, the present definition would be changed so that a group of corporations would constitute a brother-sister controlled group if (1) *the same five or fewer persons,* own at least 80 percent of the voting stock or value of shares of *each* corporation, *and* (2) *these five or fewer individuals* own more than 50 percent of the voting power or value of shares of each corporation considering a particular person's stock only to the extent that it is owned identically with respect to each corporation."

TECHNICAL EXPLANATION OF TREASURY TAX REFORM PROPOSALS ON HEARINGS ON THE SUBJECT OF TAX REFORM BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS, 91st Cong. 1st Sess., Pt. 14 at 5168 (sometimes referred to as "Technical Explanation"). (Emphasis added). There is no indication in the legislative history that the amendment was intended to relax the requirement of common ownership or "sameness" contained in prior Section 1563(a)(2), and in the regulations to Section 1551. As was the case with the General Explanation, there are no examples in the Technical Explanation which do not include common ownership by the persons included in the 80% test in each corporation.

Petitioner's reading of the above language (Pet. Brief 30-31) is plainly incorrect in that the Technical Explanation nowhere refers to the same *group* of five or fewer persons. The explanation clearly provides that the 80% test is satisfied if the same five or fewer *persons* own at least 80% of the stock of *each* corporation *and* that these

same five or *fewer individuals* also satisfy the 50% test. Both the Court of Claims in this case and the Fifth Circuit in *Delta Metalforming Co. v. Commissioner* agreed with this reading of the Technical Explanation which supports the logical conclusion "[t]hese very same five or fewer persons – only one combination with the same members – [constitute] one economic entity – [and] must comprise the asserted control group." *Delta Metalforming Co., Inc. v. Commissioner, supra* 632 F.2d at 448.

The Treasury General and Technical Explanations make clear that the vehicle for insuring that the requisite common ownership is present is the 80% test, and that the 50% test was designed to limit the application of the 80% test to situations where the common stock of the two or more corporations is held in vastly differing proportions. As described above, if Treas. Reg. §1.1563-1(a)(3) is valid, the 80% test would be rendered secondary, and the required overlap of ownership would be reduced from 80% to 50%. Congress nowhere indicated an intention to achieve this result.

The Tax Court in *Fairfax Auto Parts* discussed the expansion of the ownership group in the 1969 amendment to Section 1563(a)(2) and its relation to the requirement of common control and came to the conclusion that

> ". . . *it is obvious to us that a shareholder must be denied admission to the ownership group absent stock ownership in every member of the controlled group.* A contrary interpretation of Section 1563-(a)(2) would simply do violence to the statutory language and legislative history thereof. (Emphasis added).

Fairfax Auto Parts, supra 65 T.C. at 804-805. (Emphasis added.)

An identical trumpet was sounded by Judge Webster in his dissent in *T.L. Hunt, Inc.* when he wrote: "It is not the *smallness* of the number of persons in each company that triggers §1563; it is the *sameness* of that small number. The 80 percent financial interest requirement is meaningless unless it is the *same* group of five or fewer persons that own 80 percent of each company within the controlled group. It is this requirement of economic entity which is entirely eviscerated by Reg. §1-1563-1(a)(3)." *T.L. Hunt, Inc. v. Commissioner, supra* 562 F.2d at 537. (Webster, J., dissenting). (Emphasis not added).

This theme was reiterated by the Court of Claims in this case[10] and by the Fifth Circuit in *Delta Metalforming Co., Inc. v. Commissioner,* where both courts concluded that there was no intention on the part of Congress in amending Section 1563(a)(2) to abolish the requirement of 80% common ownership among corporations in a brother-sister controlled group. Following different paths, the courts that have invalidated Treas. Reg. §1.1563-1(a)(3) have arrived at the same conclusion: that Congress never intended to eliminate the requirements of sameness and common ownership among the persons constituting the ownership group of each corporation alleged to be a member of a brother-sister controlled group, and that Regulation §1.1563-1(a)(3) insofar as it would abolish the requirement of common ownership in the 80% test of Section 1563(a)(2)(A), is invalid. As emphasized by the Court of Claims after reviewing the legislative history evidenced by the Treasury's own explanation presented to Congress of the 1969 amendment, "we fail to understand how this document has been construed as supporting, or at least not contra-

[10]Pet. App. 21a-24a.

dicting, the interpretation of Section 1563(a)(2) made by Treas. Reg. §1.1563-1(a)(3)." (Pet. App. 20a-21a).

B. Treas. Reg. §1.1563-1(a)(3) Is Invalid In That Congress Did Not Intend To Place Minority Shareholders In A Situation Where They Could Be Deprived Of Tax Benefits Without Their Knowledge Or Participation.

Under Treas. Reg. §1.1563-1(a)(3) it is possible for a shareholder who owns more than 50% of the stock in a corporation to involve his co-shareholder in a controlled group without the co-shareholder's knowledge or participation. This follows from the fact that, under the Regulation, a person may be considered part of the ownership group of a controlled brother-sister group even though he does not own stock in each member of the controlled group. There is no indication in the legislative history that Congress ever intended to permit the Commissioner to lay a trap for an expanded group of unknowing minority shareholders. In *Fairfax Auto Parts of Northern Virginia, Inc., supra* 65 T.C. at 805, n.5 the Tax Court stated: "Individual A owns 55 percent of corporation X and individual B owns 45 percent thereof. If A were independently to enter into a second business in corporate form the corporations would be component members of a controlled group. *We cannot believe that Congress intended to surprise B with such a result.* We recognize that had A owned 80 percent of corporation X and B 20 percent thereof, the corporations would constitute a controlled group. However in the latter instance, B's unfortunate surprise would be necessitated by both the mechanical application of the stock ownership tests and the respective functions of the 80 percent and 50 percent tests . . ." (Emphasis added).

As asserted by the Petitioner (Pet. Brief 24) as well as by Judge Simpson in his dissent in *Fairfax Auto Parts of Northern Virginia, Inc., supra,* Respondent's interpretation of the statute would place great weight upon the ownership of one share of stock. *Fairfax Auto Parts of Northern Virginia, Inc. v. Commissioner, supra,* 65 T.C. at 812. In answer to the argument that the ownership of a single share of stock should not determine the existence of a controlled group, the Fifth Circuit responded that "stock ownership – or lack of ownership – or even a single share entails significant rights, opportunities and disabilities. The shareholder may vote to elect and remove directors, adopt, amend and repeal bylaws, adopt resolutions, affect extraordinary corporate matters, and see corporate books and records . . . He also has standing to bring suit against an officer or director of the corporation who breaches his fiduciary duties to the entity, or under the Securities Act of 1934." *Delta Metalforming Co., Inc. v. Commisssioner, supra* 632 F.2d at 450.

In any event, the rights of a holder of even one share of stock would provide him with sufficient notice that he may own stock in a corporation which is in a controlled group, thereby preventing the harsh surprise which is possible under Treas. Reg. §1.1563-1(a)(3). However, it is implausible that the expanded group of individuals who did not own *any* stock whatsoever in such corporation was intended by Congress to be "unknowingly" subjected to the imposition of Section 1563(a)(2) without the Congress specifically considering the impact of such an interpretation. What in fact the Petitioner is arguing against is that the objective standards established in Section 1563 which were narrowly drawn and operate in an arbitrary fashion. In this respect, the Treasury's interpretation of the statute in Treas. Reg. §1.1563-1(a)(3) goes beyond the acceptable bounds of even the

recognized "line drawing" of Congress.[11] Moreover, because the test imposed by Section 1563 is objective and involves the application of an arbitrary "line drawing," the common stock ownership in each corporation by the persons in the group must be considered a threshold criteria for application of the statute in order to limit the unfair "surprise" which the Treasury's interpretation would impose on an expanded group of minority shareholders.

C. Where The Treasury, As Part Of Its Proposals To Congress Encouraged Congress To Rely On An Interpretation Of Section 1563(a)(2) Which Was Not Consistent With The Treasury's Position Taken In Treas. Reg. §1.1563-1(a)(3), Treas. Reg. §1.1563-1(a)(3) Must As A Matter Of Law Be Inconsistent With The Congressional Purpose.

As discussed hereinbefore (*supra* at 17), the Treasury in several ways explained to the Congress that the 80% common ownership test was being preserved in the amendment to Section 1563(a)(2) and that the purpose of the 50% test was to limit the 80% test, rather than to supplant it, as the sole test of common ownership. Every example submitted by the Treasury in its explanation to the Congress involved only shareholders who owned stock in each of the member corporations. General Ex-

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[11] This is apparent from the Petitioner's attempt to minimize the Court of Claims' discussion pertaining to the "predictable actions of real taxpayers" when considering the motives for a person to make a token investment of stock only to *increase* taxes rather than to *avoid* them. (Pet. Br. 26, n.4) Contrary to Petitioner's view, it is "minute distinctions" such as the ownership of a single share of stock which triggers the application of Section 1563.

planation, *supra* at 5394-96; Technical Explanation, *supra* at 5168-70. This fact is compelling support for the Court of Claims' interpretation of the underlying meaning and purpose of the legislative history of the amendment. Moreover, the fact that the examples presented by the Treasury failed to include a single case illustrating this fundamental issue regarding the 80% test undermines support for its interpretation in Treas. Reg. §1.1563-1(a)(3). In this respect the argument that the Treasury cannot be called upon to present Congress with an exhaustive explanation of every application of an act is of little merit. First, as hereinbefore discussed, the statute itself imposes a mathematical definition making application of the percentage of stock ownership involved critical to implementation of the statute. Second, the examples submitted by the Treasury involved far more complicated patterns of ownership than the basic issue of whether or not stock ownership was a requirement for application of the 80% test. In this respect, the Treasury's General Explanation of the 1969 amendments cites one case in which the parent corporation had 516 wholly-owned subsidiaries all in the same controlled group. General Explanation, *supra* at 5388. Further, the General Explanation also refers to a 1963 Treasury survey of 55 large corporate groups, each of which averages 115 separate corporations. General Explanation, *supra* at 5391.

It is internally inconsistent for the Government to argue that Treas. Reg. §1.1563-1(a)(3) is in accord with the congressional purpose, or that Congress has implicitly adopted Treas. Reg. §1.1563-1(a)(3), when the position taken by Treasury prior to enactment of amended Section 1563(a)(2) deprived Congress of the opportunity to consider the impact of the position taken by Treasury in adopting the Regulation. In addressing this issue of

unfairness, the Court of Claims noted that: "It would be a gross usurpation of the power of Congress to draft tax statutes to allow the Treasury to explain a legislative proposal in one way and then to interpret it after enactment in a far more expansive fashion." (Pet. App. 24a).

Furthermore, Petitioner's discussion (Pet. Brief 31-33) of Section 1551(b)(2) does not rescue the strained legislative interpretation it asserts to be found in Section 1563, nor resolve the fact that an examination of the language of Section 1551(b)(2), the legislative history thereunder and the pertinent regulations all support the logical conclusion that each of the stockholders own stock in each corporation. The Treasury expressly represented to Congress that the stock ownership test of Section 1563(a)(2) would be the same as the test employed in Section 1551(b)(2). General Explanation, *supra* at 5394. Petitioner's reliance on an at best arguable *inference* drawn from a single Treasury Regulation under Section 1551(b)(2) to support its addition of the words "singly or in combination" in Section 1563(a)(2) is unconvincing. As recognized by the Court of Claims (Pet. App. 26a) "any implied congressional approval must necessarily be limited to the literal wording of the regulations and cannot be extended to a possible inference or interpretation." *Montana Power Co. v. United States,* 232 F.2d 541, 549 (3d Cir.), *cert. denied,* 352 U.S. 843 (1956). The point is that neither Section 1551 nor any of the Treasury regulations thereunder include the words "singly or in combination." The best the Treasury can do is claim support for their interpretation in Treas. Reg. §1.1551-1(g)(4), Example 4. However, when closely examined, that example in the context of both the legislative history of Section 1551(b)(2)and the other exam-

ples[12] in the regulations under Section 1551 supports a conclusion that the ambiguity between the conflicting regulations is resolved by concluding that common ownership by each stockholder is required. (Pet. App. 26a-28(a)). See, Bonovitz, *supra*, 28 TAX LAWYER at 519-530. As noted by both the Court of Claims (Pet. App. 27a) and the Fifth Circuit in *Delta Metalforming Co., Inc. v. Commissioner, supra* 632 F.2d at 450-451, Example 4 cited by Petitioner can be further distinguished because "the example merely illustrates that a transfer can be made by one, rather than all, of the individuals in control of the transferor corporation or that the controlling stockholders of the transferee corporation must come from the group of five or fewer shareholders of the transferor but need not include all of the members of that group." (Pet. App. 27a). Petitioner's interpretation of support under Section 1551 for the Treasury's position is at best based only on an ambiguous example. In contrast to this view, it is logical that if Congress intended to adopt the expansive view subsequently promulgated by the Treasury in Treas. Reg. §1.1563-1(a)(3), it would have specifically addressed the question at the time of congressional enactment.

Similarly, Petitioner's attempt to gain support from application of the theory of legislative re-enactment illustrates the weakness of its position. As a general rule and as acknowledged by the Court of Claims in this case "[r]e-enactment – particularly without the slightest

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[12]Treas. Reg. §1.1551-1(f)(2) ex. 2 can be interpreted as supportive of the taxpayer's position, while Treas. Reg. §1.1551-1(g)(4) ex. 4 seems to indicate that the 'ownership of a person could be taken into consideration for purposes of the 80% test even though the taxpayer did not own stock in some of the corporations and was therefore not considered for the purposes of the 50% test.' 65 T.C. at 807.

affirmative indication that Congress ever had before it the particular construction in question – is unreliable indicium at best." (Pet. App. 24b) *citing Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). In this respect the fact that Section 1015 of the Employee Retirement Income Security Act of 1974 (ERISA), Pub.L. No. 93-406, 88 Stat. 925 added Section 414(b) of the Internal Revenue which incorporated the control test of Section 1563(a) at a time when the regulations thereunder were issued does not support the view that it was the Congress' intention to readopt Treas. Reg. §1.-1563-1(a)(3). First, there is no specific mention of the fact that Congress affirmatively addressed the regulation. Second, as noted by the Court of Claims "[b]ecause of the short periods between the publication of each regulation under Section 1551(b)(2) and 29 months in the case of Treas. Reg. §1.1563-1(a)(3)), congressional approval of the regulations cannot be implied." (Pet. App. 25a). The Court has in the past refused to give any significance to the re-enactment of a provision as part of the Internal Revenue Code without some affirmative indication that Congress has considered the question for example where only 3 years elapsed after the initial regulation in question. *United States v. Calamaro*, 354 U.S. 351, 358-59 (1957). *Accord, Commissioner v. Sun Pipe Line Co.*, 126 F.2d 888, 892 (3d Cir. 1942); *Commissioner v. F.H.E. Oil Co.*, 102 F.2d 596, 598 (5th Cir. 1939), *aff'd*, 308 U.S. 104 (1939).[13]

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[13]There is similarly little merit to Petitioner's attempt (Pet. Brief 34, n.7) to bootstrap the fact that the American Bar Association's Tax Section 1974 recommended amendment to Section 1563(a) (Tax Section Recommendation No. 1974-1 (A.B.A.), 27 TAX LAWYER 813, 817 (1974)) was never enacted into law. In this respect, there is little to indicate the full Congress' con-

[footnote continued]

CONCLUSION

For the reasons stated, Dixie Realty Company, Inc. and Dixie Furniture Co., Inc., as *amici curiae*, respectfully urge that the judgment of the United States Court of Claims be affirmed.

Respectfully submitted,

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sideration of the matter and its affirmative discussion not to change the statute. Rather than reliance upon an extremely unreliable theory attempting to glean some meaning from Congress' failure to adopt a specific legislative proposal, the underlying purpose of the ABA amendment better stands for the fact that the Treasury Regulation under review in this case was viewed as an improper and unreasonable interpretation by the Treasury of Section 1563(a)(2).

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No. 80-1251

THE SUPREME COURT OF THE UNITED STATES
October Term, 1980

United States of America, Petitioner

v.

Vogel Fertilizer Company, Respondent

On Writ of Certiorari
To The United States Court of Claims

BRIEF OF AMICUS CURIAE

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BRIEF OF AMICUS CURIAE

INTEREST OF THE AMICUS CURIAE

The amicus curiae are four corporations organized and existing under the laws of the State of Colorado where they are engaged in the business of banking. The amicus curiae will be referred to as the "Banks." The names and locations of the Banks are as follows:

The Minnequa Bank of Pueblo	Pueblo, Colorado
The Bank of Aspen	Aspen, Colorado
First National Bank of Durango	Durango, Colorado
Bank of Monte Vista	Monte Vista, Colorado

In 1974 and 1975, the number of shareholders of each Bank ranged from 18 to 50. Control of each Bank rested with Mahlon T. White and Helen T. White who together owned, directly or indirectly, a majority (but not 80% or more) of the single class of stock of each Bank. A group of five or fewer individuals, including the Whites, owned at least 80% of the outstanding stock of each of the Banks. However, because the minority shareholders varied from Bank to Bank, the members of the 80% ownership group differed from Bank to Bank. Only Mahlon T. White and Helen T. White were

members of the 80% ownership group of each Bank. Other shareholders owned stock in only one Bank.

In computing their respective tax liabilities for 1974 and 1975, the Banks each utilized a full surtax exemption pursuant to Section 11(d) of the Internal Revenue Code (the "Code"). The Commissioner of Internal Revenue determined that the Banks constituted component members of two separate brother-sister controlled groups of corporations, as defined by Section 1563(a)(2) of the Code and Section 1.1563-1(a)(3) of the Treasury Regulations. Therefore, the Banks were paired into two controlled groups, and the two Banks in each group were required to share a single surtax exemption pursuant to Section 1561(a)(1) of the Code.

On March 6, 1979, each of the Banks filed a petition before the United States Tax Court, contending that it was entitled to a single surtax exemption for taxable years 1974 and 1975 and praying for relief consistent with that contention. The captions of the cases and their United States Tax Court docket numbers are set forth below:

The Minnequa Bank of Pueblo	2866-79
The Bank of Aspen	2867-79
First National Bank of Durango	2868-79
Bank of Monte Vista	2869-79

Following the filing of answers by the Commissioner of Internal Revenue as respondent, the parties in each case filed a joint motion to consolidate the four cases, which motion was granted by the United States Tax Court on February 25, 1980. The parties agreed to and filed a stipulation of facts, and briefs were filed on April 10, 1980. The United States Tax Court has not yet

rendered an opinion on the issue raised by the Banks.

The Banks believe that the issue presented in their case before the United States Tax Court is identical to the issue now before this Court. The question presented is whether, for purposes of the 80% test under Section 1563(a)(2)(A) of the Code, a person must own stock in each and every corporation of the alleged brother-sister controlled group of corporations. Accordingly, the Banks have sought and obtained the written consent of the parties to this case to file a brief of an amicus curiae, pursuant to Rule 36.2 of the Supreme Court Rules.

SUMMARY OF ARGUMENT

The United States Tax Court already has decided this issue six times in favor of the taxpayer. Recently, the Tax Court analysis was affirmed by the Fifth Circuit Court of Appeals and was followed by the United States Court of Claims. These prior holdings are correct, and Respondent should prevail in this case, because (i) the language of the statute itself supports Respondent, (ii) the legislative history of the statute supports Respondent, and (iii) policy considerations support Respondent.

ARGUMENT

RESPONDENT IS NOT A MEMBER OF A BROTHER-SISTER CONTROLLED GROUP OF CORPORATIONS WITHIN THE MEANING OF SECTION 1563(a)(2) OF THE INTERNAL REVENUE CODE.

The facts of the case before this Court are adequately set forth in Petitioner's brief and will not be repeated. The legal issue presented arises in Section 1563(a)(2) of the Code. As amended in 1969, Section 1563(a)(2) provides that a brother-sister controlled group consists of:

> Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own . . . stock possessing--
>
> (A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and

> (B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.

Because of the majority stockholding of Arthur Vogel in Vogel Fertilizer Company and Vogel Popcorn Company, the parties evidently agree that the 50% test set forth in Section 1563(a)(2)(B) was met in the taxable years in issue. The parties disagree only as to the proper application of the 80% test of Section 1563(a)(2)(A). Respondent contends that the five or fewer persons who own 80% or more of the stock in one alleged member of a controlled group must be the same persons who own 80 percent or more of the stock in the other alleged member. Because Richard Crain owned stock only in the

Respondent and because his interest in that corporation exceeded 20%, the 80% test could not have been met with respect to Respondent and Vogel Popcorn Company.

Petitioner relies on Treasury Reg. § 1.1563-1(a)(3). Contrary to the legislative history of Section 1563, the regulations do not require that each of the same five or fewer persons own at least 80% of the voting stock or value of shares of each corporation. Instead, they make the sweeping interpretation that the 80% ownership test is met where any five or fewer persons "singly or in combination" own stock of the two or more corporations.

On at least six occasions, the United States Tax Court has declared the regulation relied on by Petitioner invalid. The issue was first decided in January 1976 in Fairfax Auto Parts of Northern Virginia,

Inc. v. Commissioner, 65 T.C. 798 (1976), a decision reviewed by the entire court. In July 1976, the Tax Court followed its Fairfax decision in T.L. Hunt, Inc. v. Commissioner, 35 T.C. Memo 966 (1976). In January 1977, the Fourth Circuit, in a per curiam opinion, reversed the Fairfax decision, and in October 1977, this Court denied certiorari in the case. Fairfax Auto Parts, Inc. v. Commissioner, 548 F. 2d 501 (4th Cir. 1977), cert. denied, 98 S. Ct. 300 (1977). In light of the Fourth Circuit reversal, the Tax Court reconsidered the validity of the regulation in Charles Baloian v. Commissioner, 68 T.C. 620 (1977), but in a reviewed opinion held again in favor of the taxpayer. In the face of a subsequent appellate court reversal [T.L. Hunt, Inc. of Texas v. Commissioner, 562 F.2d 532 (8th Cir. 1977)] the Tax Court

adhered to its reasoning in Fairfax three more times. Delta Metalforming Co., Inc. v. Commissioner, 37 T.C. Memo 1485 (1978); Allen Oil Company, Inc. v. Commissioner, 38 T.C. Memo 355 (1979); Davidson Chevrolet Company v. Commissioner, 39 T.C. Memo 299 (1979). The Allen Oil decision subsequently was reversed by the Second Circuit. Allen Oil Company, Inc. v. Commissioner, 80-1 U.S.T.C. ¶ 9156 (2d Cir., January 11, 1980). However, on December 8, 1980, the Fifth Circuit became the first Court of Appeals to affirm the Tax Court and hold that a person must own stock in each member of an alleged brother-sister controlled group to satisfy the 80% test under Section 1563(a)(2)(A). Delta Metalforming Co., Inc. v. Commissioner, 632 F.2d 442 (5th Cir. 1980), petition for cert. pending, No. 80-1499 (filed March 4, 1981). The Delta

Metalforming decision came soon after the United States Court of Claims decision giving rise to the case before this Court. See Vogel Fertilizer Company v. United States, 634 F.2d 497 (Ct. Cl. 1980).

The Tax Court's position, as affirmed by the Fifth Circuit and followed by the Court of Claims, is correct for three basic reasons:

I. THE LANGUAGE OF SECTION 1563 ITSELF SUPPORTS RESPONDENT.

The language of the statute itself is not susceptible to the sweeping interpretation of the statute set forth in the regulation. The significant words of the statute with respect to the issue are: "if 5 or fewer persons . . . own . . . (A) at least 80% . . . of each corporation, and (B) more than 50% . . . of each corporation, taking into account the stock ownership of

each such person only to the extent such stock ownership is identical with respect to each such corporation."

First, it is clear that the phrase "5 or fewer persons" is the conjunctive subject of both the 80% test and the 50% test. This sentence structure in itself specifies that the same five or fewer persons are required for both tests. Second, the term "such person" in the 50% test is a direct reference back to the same "5 or fewer persons" designated for consideration in connection with the 80% test. Finally, the term "each such person" in the 50% test, which refers back to the "5 or fewer persons" specified in the 80% test, must mean that each of those persons and not just some of those persons who are counted as owning stock for the 80% test also must own stock for purposes of the 50% test. The

regulation ignores this thrust of the language of the statute by including for purposes of the 80% test persons who cannot be included in meeting the 50% test because they do not own stock in all the corporations involved.

Moreover, an analysis of the manner in which the language of Section 1563(a)(2)(A) was in fact amended in 1969 makes it all the more evident that the regulation represents a totally impermissible construction of the statute. Prior to the 1969 amendment, Section 1563(a)(2) provided that two or more corporations constituted a controlled group if "at least 80% . . . of each of the corporations is owned . . . by one person." [Emphasis supplied.] With respect to the 80% test, the 1969 amendment merely increased the size of the ownership group in order to reach situations where "5

or fewer persons . . . own . . . at least 80% . . . of each corporation." [Emphasis supplied.]

Since the original definition was read as requiring that each corporation in the group be owned by the same person, the mere increase in the size of the ownership group from one to five can be taken only as authority for now permitting the 80% test to be satisfied where a larger number of the same persons comprise the ownership group of each corporation. Yet the regulation reaches well beyond this authority.

II. THE LEGISLATIVE HISTORY OF SECTION 1563 SUPPORTS RESPONDENT.

The surtax exemption of Section 11(d) was designed to stimulate the formation of capital by providing a tax incentive for incorporators of small businesses. A lower tax rate was applied to the first

dollars earned by a corporation. The exemption, however, was subject to possible abuse through the use of the multi-corporate structure. A corporate owner could gain the advantage of two or more surtax exemptions, simply by operating his business through two or more corporations. Prior to the enactment of Section 1561 in 1964 the Commissioner had various ways to attack such abuses. Through Sections 269, 1551, 482, 61, and the common law theories of "assignment of income," "disregard of corporate entity," and "sham transaction," the Commissioner could minimize the procurement of additional surtax exemptions through the use of multiple corporations. The efficacy of these devices was limited, however, because the Commissioner was usually required to demonstrate a "tax avoidance

purpose" as a prerequisite to their application.

The Revenue Act of 1964 for the first time provided a mechanical limitation upon the abilities of "multiple corporations" to enjoy the benefits of multiple surtax exemptions. Under Sections 1561 and 1563, if the percentage ownership tests of either a parent-subsidiary controlled group or a brother-sister controlled group were met, the entire group of corporations was required to share a single surtax exemption without further inquiry into whether the structure was motivated by tax avoidance or legitimate business purposes. As noted above, the 1964 Act defined a brother-sister controlled group as two or more corporations where <u>one</u> individual owned 80% or more of the stock of each.

Finding that the 80% ownership test by one individual was easily circumvented, the Treasury proposed to broaden the definition of brother-sister controlled group contained in Section 1563. The Tax Reform Proposals presented by the Treasury in April 1969 urged that the definition of a brother-sister controlled group should be changed "so that a group of corporations would constitute a brother-sister controlled group if (1) the same five or fewer persons own at least 80% of the voting stock or value of shares of each corporation, and (2) these five or fewer individuals own more than 50% of the voting power or value of shares of each corporation considering a particular person's stock only to the extent that it is owned identically with respect to each corporation. This definition is the same as that under Section 1551." [Emphasis partly

supplied.] Hearings on Tax Reform, Tax Reform Proposals Presented by Representatives of the Treasury Department, 91st Congress, 1st Session, p. 194 (referred to as "Hearings"). Congress adopted the new definition as recommended. In light of the foregoing statement, the regulation clearly is improper, since under the regulation the "same" persons are not required to own 80% of "each" corporation in the group.

But the Treasury Proposal went even further. It also stated that the 80% test would be satisfied "if the group of five or fewer persons as a whole owns at least 80% . . . of each corporation." [Emphasis supplied.] Hearings, supra. By contrast, the regulation does not even remotely contemplate that the "whole" group will own 80% of each corporation.

Finally, the illustrative examples that were offered conclusively establish that the original Treasury Proposal was not submitted with the regulation in mind:

> For example [the 80% test but not necessarily the 50% test] is met whether one person owns 80% of the voting stock of each corporation, four persons each own 20% of the voting stock of each corporation, or one person owns 60% of the voting stock of one corporation and 40% of another, and another person owns 40% of the voting stock of the first and 60 percent of the second.

Hearings, supra. Each of the examples indicate a requirement of common ownership in each of the corporations. If a broader interpretation of the statute had been intended, appropriate examples surely would have been supplied in the Treasury Proposal.

While neither the House nor the Senate Committee Report offers as full an explanation of the 80% test as the Treasury

Proposal (see H. Rep. 91-413, 1969-3 C.B. 262, 384; S. Rep. 91-552, 1969-3 C.B. 509-10), they contain no language that is contradictory. Moreover, the Supplemental House Report reiterates that the new stock ownership test of Section 1563(a)(2) "would be the same test employed in Section 1551(b)(2) of the Code," a statement that first appeared in the Treasury Proposal. H. Rep. 91-413, 1969-3 C.B. 384.

Section 1551(b)(2) and the regulations thereunder require that the same persons who meet the 50% test also meet the 80% test. In Reg. § 1.1551-1(f)(2), Example (2), A owns all of the stock of X Corporation and 60% of Y Corporation. The ownership of the remaining 40% of Y Corporation is not disclosed. In a later year, A acquires an additional 20% of Y Corporation and only thereafter do the

corporations meet the 50% and 80% ownership tests. The result in this example shows that the intent of the regulation is to require all persons whose stock ownership is considered in meeting the 80% test to own some stock in each corporation. Since A owned all of the stock of X Corporation, only his ownership in Y Corporation is deemed relevant for this purpose. Likewise, in Example (3) of Reg. § 1.1551-1(f)(2), Section 1551 is not deemed applicable to a situation in which individuals A and B each own 50% of X Corporation and A owns all the stock of Y; however, when B buys 50% of the stock of Y, Section 1551 is held to be applicable to X and Y.

The test under Section 1551(b)(2) is phrased, in all relevant respects, in precisely the same language as the amendment to Section 1563(a)(2). Since it is clear

that Section 1551(b)(2) applies only where precisely the same five or fewer persons compose the 80% ownership group of each of the two corporations involved, it is evident that Congress believed it was adopting the Respondent's interpretation of Section 1563(a)(2)(A), rather than the interpretation contained in the regulation.

III. POLICY CONSIDERATIONS SUPPORT RESPONDENT.

The purpose of Section 1563 was to replace the subjective tests of Sections 269, 482, and 1551 with an objective definitional test. The statute sought to deter the use of two or more corporations primarily for tax purposes where the nontax results would be generally the same if only one corporation were used. This was a recognition that purpose is still part of the rationale, but the statute seeks to test

for purpose by an objective standard--several corporations controlled like one. In the situation where the individuals control one of the corporations but not the other, the nontax results differ decidedly from the use of one corporation. The 50% test, which assures common control of all corporations involved, is the test which assures that the statute will be applied to any multiple corporation situation which has the control features resembling one corporation. Thus, the 50% test--the control test--actually tests for the most salient feature of the improper tax use of several corporations and must be viewed as the primary test under the statute.

If the 50% test is the primary test, then the drafters of the statute must have felt something in addition to control was required. The function of the 80% test

is to require that the five or fewer persons in control have an aggregate ownership which represents substantially the entire financial interest in all corporations involved. Congress could have required that the five persons in control own 100% of the equity in each corporation. However, this would have made it easy to avoid the section by placing a nominal amount of stock in outside hands. On the other hand, Congress could have been satisfied with anything over 50% as the requisite financial interest for those in control. But Congress went further, requiring in addition to control that those persons in control have a substantial financial interest in the corporations, i.e., 80%.

A financial interest test is needed because the conduct sanctioned by the statute is the exercise of common control by a small group of persons over more than one

corporation (the 50% test) for the purposes of their own substantial financial interest in those corporations (the 80% test). Since this is the function of the 80% test, the 80% stock ownership requirement of the statute cannot be met with stock owned by a person who is outside the control group. To interpret the statute so that the 80% test can be met by persons having ownership in only one corporation ignores the obvious relationship between the 50% test and the 80% test, i.e., the exercise of control by persons with a substantial financial interest in the corporations.

This point was emphasized in the dissenting opinion by Judge Webster in the Court of Appeals for the Eighth Circuit in T. L. Hunt, supra:

> . . . It is not the smallness of the number of persons in each company that triggers § 1563; it is the sameness of that small number.

> The 80% financial interest requirement is meaningless unless it is the <u>same</u> group of five or fewer persons that own 80% of each company within the controlled group. It is this requirement of "economic entity" which is entirely eviscerated by Reg. § 1.1563-1(a)(3).

If Congress had intended that there be only a simple test of 50% ownership, the language of the statute would have more clearly expressed this intent. Although the 80% test may in fact be a secondary test, it is important insofar as it includes the common investment interests of the shareholders in order to determine whether or not two or more corporations are essentially the same entity in determining the stockholders' financial interest. The logic and rationale supporting the concept of one economic enterprise was carried over in the expansion of the statute in 1969 when the 80% test was

expanded from one person to five or fewer persons.

There is no sound policy supporting the interpretation of the statute that the regulation espouses. The regulation offers the following example of its interpretation of the statute:

> Example (1). The outstanding stock of corporations P, Q, R, S, and T, which have only one class of stock outstanding, is owned by the following unrelated individuals:

Indi-	CORPORATIONS					Indentical
viduals	P	Q	R	S	T	Ownership
A	60%	60%	60%	60%	100%	60%
B	40%					
C		40%				
D			40%			
E				40%		
TOTAL	100%	100%	100%	100%	100%	60%

> Corporations P, Q, R, S, and T are members of a brother-sister controlled group. See Reg. § 1.1563-1(a)(3)(ii), Example (1).

Suppose A also had owned 60% of a sixth corporation in which F was the other shareholder. Why should a controlled group be deemed to include the four corporations, owned 60% each by A and 40% owned by B, C, D, and E respectively--but not a sixth corporation owned 60% by A and 40% by F? Because the 80% test of the regulation is limited in its application to corporations owned 80% or more by "five or fewer persons," the sixth corporation presumably would not be included in the controlled group since F is the sixth person. But is the sixth corporation any less commonly owned and controlled than the other corporations? The 80% test as interpreted by the regulation draws a totally artificial line by arbitrarily excluding a corporation with a pattern of ownership that is identical to every corporation in the

group. From a policy standpoint, either all corporations owned 60% by A and 40% by other persons should be covered by the statute, or none of them should be.

In the regulation's example, none of the persons making up the ownership group have any common control or ownership except for A. Reading the eighty percent test in such a manner insures not that the same persons own a substantial financial interest in each corporation but merely that each corporation will be a closely held corporation. Since the purpose of the section 11(d) surtax exemption evidently was to benefit closely held corporations, such a result is untenable.

Moreover, the regulation's interpretation of the statute is troublesome for equitable reasons. It seems unfair that the Treasury should be allowed to so

dramatically expand the impact of a statute by its regulations when, in every one of the examples that it presented to Congress during the hearings, it failed to include a pattern of ownership similar to that which was ultimately adopted by it in the regulations.

Finally, the Treasury interpretation of the statute will lead to situations where persons who own stock in only one corporation will be surprised to find that their corporations are part of a controlled group and that their single holdings are contributing to that result. The possibility that upset the Tax Court majority in Fairfax, supra, was as follows:

> Individual A owns 55% of corporation X and individual B owns 45% thereof. If A were independently to enter into a second business in corporate form the corporations would be component members of a controlled group. We cannot believe that Congress intended to

surprise B with such a result. 65 T.C., at 805.

A similarly unfavorable situation would occur if A already owned one business and then formed a second unrelated business with B. If A owned fifty-five percent of the stock of the second business and B owned forty-five percent of the stock, under the regulation a brother-sister controlled group would be formed. The law therefore would dictate the absurd proposition that before B goes into business with A, he must investigate all of A's other ho dings to make sure that A and B together are not running two or more businesses as a single economic entity.

This situation is exactly that in which Richard Crain, the minority shareholder of Respondent, finds himself. Under Petitioner's interpretation of the statute, Mr. Crain causes Respondent and Vogel

Popcorn Company to be members of a controlled group of corporations, even though he owns stock only in Respondent. As a result, Mr. Crain's corporation must share a corporate surtax exemption with another corporation even though he has no interest in that other corporation.

The Tax Court has heard these arguments many times in the past. Even in the face of appellate court reversals, it has stood firm in requiring the Treasury to refrain from lawmaking and to interpret accurately the will of Congress. The overwhelming majority of the commentators has applauded the Tax Court's adherence to reason and Congressional intent. See Bonovitz, "Brother-Sister Controlled Groups Under Section 1563: The 80 Percent Ownership Test," 28 Tax Lawyer 511 (1975); Libin and Abramowitz, "Multiple

Corporations: A Surprising Interpretation of Sec. 1563(a)(2) in Temporary Regulations," 3 Tax Adviser 326 (1971); Thomas, "Brother-Sister Multiple Corporations--The Tax Reform Act of 1969 Reformed by Regulation," 28 Tax Law Review 65 (1972); Nathanson, "Fairfax Auto Parts, Inc. v. Commissioner: Definitional Requirements of the Multiple Corporation for Purposes of Exclusion from Surtax Exemptions," 32 Univ. of Miami L. Rev. 461 (1977); Weisman, "Brother-Sister Controlled Corporations: On and Off the Road to the Supreme Court with an Edsel," 56 Taxes 475 (1978); Committee Recommendations, Committee on Affiliated and Related Corporations, Section of Taxation, American Bar Association, 27 Tax Lawyer 813 (1974). Recently, courts of appeal have joined the Tax Court to rebuff the Treasury's intrusion

into the legislative process. With so much authority behind it, this Court should follow the Tax Court decision in Fairfax, supra, and hold summarily for Respondent.

CONCLUSION

For the reasons stated, the judgment of the Court of Claims should be affirmed.

Respectfully submitted,

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